Cooley

Delaware Supreme Court Changes Conversation on Director Compensation

March 30, 2018

In recent years, there has been an increase in Delaware breach of fiduciary duty claims (including stockholder demands and actual cases) asserted against public company boards alleging that the directors engaged in self-dealing and corporate waste by approving their own pay at excessive levels. In response, an increasing number of companies have included director compensation limits in stockholder-approved equity plans as a strategy for deterring and defending breach of fiduciary duty claims alleging that the directors received excessive compensation. However, a recent decision by the Delaware Supreme Court – *Investors Bancorp*[1] – raises questions about the effectiveness of these limits and the best way to proceed going forward.

What is the difference between the business judgment and entire fairness standards of review and why does it matter?

A court's threshold determination of whether to apply the "business judgment" standard or the "entire fairness" standard of review to a claim involving a breach of fiduciary duty has significant consequences. Board decisions are generally insulated from judicial scrutiny and the potential imposition of personal liability on the directors by the "business judgment rule" standard of review under Delaware corporate law. If the business judgment rule applies, there is a presumption that the board acted in good faith and in the best interest of the company's stockholders so that a court will not second-guess the board's business decision. A plaintiff may overcome the presumption of the business judgment rule by proving that a majority of the board was interested or lacked independence, or that the board acted in bad faith, breached its duty of care or loyalty, or committed corporate waste. This is a high burden of proof. As such, it is more typical to see a dismissal of claims at an early stage where the business judgment rule applies.

A board decision to set director compensation is a self-interested one because the directors are deciding how much to award themselves for board service. As a result, such a decision is not typically entitled to the presumption of the business judgment rule. Rather, it is usually reviewed under the "entire fairness" standard, which involves far more scrutiny. There, the burden falls upon the board to prove that the transaction was entirely fair to the company and its stockholders. It is more challenging for companies to achieve a dismissal of claims under this standard of review, and, as a result, it is more likely that a financial settlement will be required in order to avoid the even more costly path (both in terms of time and money) of continuing the litigation to conclusion.

A board can avoid the entire fairness review and receive the benefit of the business judgment rule in claims involving board compensation if the company's stockholders ratify the self-interested transaction. That is, if a majority of fully informed, uncoerced, and disinterested stockholders approved the awarded board compensation, then the deferential business judgment standard of review would apply.

Why have companies begun including director compensation limits in equity plans in recent years?

Before *Investors Bancorp*, the Delaware Chancery Court recognized the stockholder ratification defense for director compensation where the compensation was awarded pursuant to a discretionary plan that was approved by the stockholders and contained "meaningful limits" on director compensation. Given the deferential standard of review, companies were often able to secure early dismissal of claims at the initial pleading stage. In those cases, by approving the plan limits, the stockholders were viewed as having removed the taint of director self-interest through their ratification of the payments made under the plan's terms. This principle had become so well-accepted that, in recent years, many companies seeking to mitigate the risk of excessive director pay claims have added director pay limits to their equity plans when submitting them for stockholder approval.

How does *Investors Bancorp* change things?

The recent *Investors Bancorp* decision by the Delaware Supreme Court may be read to reject the principle that having a stockholder-approved plan that includes a meaningful limit on director pay is sufficient to invoke the business judgment rule, potentially eliminating the possibility that claims of excessive director pay may be dismissed at the pleading stage. As described below in more detail, companies may want to consider taking various actions to address this change in the landscape.

What were the facts and judicial reasoning of the decision?

The facts of the *Investors Bancorp* case were particularly egregious. The stockholder-approved limit on director compensation was set at 30% of all options or restricted shares available for awards under the equity plan, and awards covering the entire limit could be granted in a single calendar year. Within days after obtaining stockholder approval of the equity plan, the Investors Bancorp board granted itself equity awards totaling $21,594,000 in value and averaging $2,159,400 per director. These award values significantly exceeded the board's pay in the prior year, which ranged from $97,200 to $207,005 per director, as well as the median director pay at similarly sized companies ($198,000) and much larger companies ($260,000).

The Delaware Chancery Court found that, because the 30% equity plan pool limit was a specific measureable limit that was separately applicable to director awards, it was a "meaningful limit" approved by the stockholders. Accordingly, the Chancery Court applied the business judgment rule and dismissed the lawsuit for failure to state a claim. On appeal, the Delaware Supreme Court did not expressly address whether the 30% equity pool award limit approved by the stockholders was "meaningful."[2] Rather, in reversing the Chancery court, the Delaware Supreme Court found that, although the stockholders had approved the "general parameters" of the equity plan in approving the 30% limitation, they had not approved the directors' "specific awards." As a result, it held that the business judgment rule did not apply. In its opinion, the Delaware Supreme Court drew a distinction between grants made under stockholder-approved plans that do not give boards discretion to determine award levels, which are subject to the business judgment rule, and plans that do give the board that discretion, which are analyzed under the entire fairness standard.

Is there any way to guarantee that the grant of awards to directors will receive the benefit of the business judgment rule?

The Delaware Supreme Court decision in *Investors Bancorp* reaffirms that stockholder approval of "specific awards" or "self-executing" plans, where no further discretion can be exercised by the board in setting its own pay, will still provide a ratification defense.[3] The use of such structures (often called "formula plans") would ensure application of the business judgment rule in the context of excessive pay claims under Delaware law. It remains to be seen whether concerns about litigation risks following *Investors Bancorp* will trigger an increase in the use of those types of plans.

How will limits currently in plans now be viewed in the context of litigation?

It is uncertain whether a stockholder-approved "limit" or "range" – even one that is reasonable in amount and relative to peers – will by itself, be sufficient to invoke the business judgment rule. The Delaware Supreme Court had an opportunity to discuss whether the "meaningful limit" test survived in any form, and it did not address that question. It will be left up to lower Delaware courts to interpret and apply the *Investors Bancorp* decision. Accordingly, even where a stockholder-approved plan contains limits on director pay that would historically have been viewed as "meaningful" and entitled to business judgment protection, a Delaware court may apply the entire fairness standard, making it practically impossible to get an excessive pay suit involving such a plan dismissed at the pleading stage.

In considering the *Investors Bancorp* stockholder-approved limit, the Delaware Supreme Court's apparent latching on to the ability of directors to exercise discretion, rather than whether or not the limit was in fact meaningful, does not seem consistent with the underlying policy considerations and may have been driven by the particularly egregious facts of the case. For example, it seems counterintuitive to apply the deferential business judgment rule where stockholders have approved specific director awards of $200,000 per year, but apply the more rigorous entire fairness standard where stockholders have approved a $200,000 cap that allows directors to exercise discretion to pay themselves *less*. Following the *Investors Bancorp* decision, it is unclear what amount of "director discretion," if any, is permissible without triggering an "entire fairness" review. Hopefully, the Delaware courts will clarify this issue in a manner that will continue the viability of the meaningful limit test, allowing boards to invoke the stockholder ratification defense and obtain the benefit of the business judgment rule, notwithstanding the exercise of some level of board discretion.

What can companies do now?

Pending further clarification from the Delaware courts on the scope and application of the *Investors Bancorp* decision, Delaware companies should consider the following:

- While it is not clear whether the concept of stockholder ratification of meaningful limits remains viable after this decision, it may be that future cases with less egregious facts will restore the concept from the prior line of cases. Consequently, it is advisable to retain existing plan limits until there is greater clarity on this point. That said, we consider companies with a fixed share limit (as opposed to a limit denominated as a cash value) a higher risk, particularly where the company's stock price has increased significantly since stockholder approval of the plan (and the associated limit).
- We view it as unlikely that, in the short term and absent greater clarity from the Delaware courts, many companies will set up formula plans with fixed grants. However, it is certainly an alternative that could be considered, particularly for companies that otherwise seek annual stockholder approval of an equity plan and could therefore change the size of the fixed grants annually, if appropriate.
- For new plans, and existing plans that are being re-approved, where plans with fixed grants are not desirable, plan limits should be carefully determined (or re-determined, as the case may be) to ensure that they are indeed meaningful (including having been established after a thorough analysis of peer group director compensation), and that they relate to both cash and equity compensation.
- Apart from the plan itself, and regardless of whether the plan has a limit, ensure that there is a rigorous process relating to the setting of director compensation, including:
    - use of a compensation consultant;
    - an annual review of director compensation;
    - comparison against peers to confirm grants are in an appropriate range; and
    - a rigorous process around the determination of which companies are peer companies for this purpose.
- For annual proxy disclosures relating to director compensation, companies should consider going beyond the disclosure requirements and further describing the thoughtful process and any market-based analysis used to determine director compensation to deter plaintiff firms selecting their next targets. That, particularly in combination with a meaningful, stockholder-approved limit, may serve to dissuade plaintiff firms from viewing the company as an attractive target for litigation.

We will continue to alert you on developments in this area as the case law evolves. If you have any questions about this alert, please do not hesitate to contact one of the attorneys listed here.

Notes

1. *In re Investors Bancorp, Inc., Stockholder Litigation, No. 169, 2017 (Del. Supr. Dec. 13, 2017; revised Dec. 19, 2017).*
2. *In re Investors Bancorp, Inc. Stockholder Litig.*, C.A. No. 12327-VCS, 2017 (Del. Ch. Apr. 5, 2017).
3. In *Investors Bancorp*, the Delaware Supreme Court acknowledged, among others, the lower court decisions in *Steiner v. Meyerson*, 1995 WL 441999 (Del. Ch. July 19, 1995), and *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. Mar. 11, 1997) – two opinions recognizing the ratification defense where the challenged director compensation was awarded under a self-executing equity compensation plan, which was specific as to amount and value. For example, in *Steiner*, the plan granted each non-employee director "an option to purchase 25,000 shares upon election to the Telxon board, and an additional 10,000 shares on the anniversary of his election while he remains on the board." Similarly, in *Lewis*, the plan provided for two categories of director compensation: (i) one-time grants of 15,000 option shares per director; and (ii) annual grants of up to 10,000 option shares per director depending on length of board service.

assistance of artificial intelligence (AI) in accordance with our AI Principles, may be considered Attorney Advertising and is subject to our legal notices.

Key Contacts

Peter Adams **San Diego**	**padams@cooley.com** **+1 858 550 6059**
Koji Fukumura San Diego	kfukumura@cooley.com +1 858 550 6008
Chadwick Mills San Francisco	cmills@cooley.com +1 650 843 5654
Barbara Mirza Santa Monica	bmirza@cooley.com +1 310 883 6465
Cydney Posner San Francisco	cposner@cooley.com +1 415 693 2132
Thomas Welk San Diego	twelk@cooley.com +1 858 550 6016