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Client Alert

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Director Compensation Awards Withstand Stockholder Challenge

Director compensation induces qualified individuals to join and remain on boards. It also compensates directors for the increasing demands of board service. Director compensation decisions, however, can be challenged as "self-dealing" transactions when the board sets its own pay. But a recent Delaware decision confirms that equity awards to directors will be protected by the business judgment rule when made pursuant to established limits set forth in a stockholder-approved compensation plan. Boards should work with outside advisors in setting director compensation and consider including sufficient parameters in their equity plans that, following stockholder approval, will protect the board's grant decisions.

Background

In *In re Investors Bancorp, Inc. Stockholder Litigation*, a stockholder challenged equity awards made to directors of a publicly traded bank holding company.[1] The awards were made under a stockholder-approved equity plan that capped the total number of awards that could be made over the plan's term. It also provided that the maximum number of awards that could be granted to non-employee directors, in the aggregate, was 30% of all available awards. It further provided that "all of [the non-employee director awards] may be granted in any calendar year." The plan does not appear to have capped the awards any individual director could receive annually or in the aggregate.

After the plan was approved by stockholders, the board granted significant equity awards to each director. Five stockholders then brought derivative suits, alleging the directors had breached their duty of loyalty by granting awards to themselves. The court noted that the awards appeared to be "quite large," with the plaintiffs alleging that the aggregate grant date fair value was $51.5 million.

The Court's Analysis

The primary issue before the court was whether equity awards made pursuant to the bank's stockholder-approved plan were protected by the business judgment rule or subject to the stringent "entire fairness" standard.

First, the court held that, to be protected by the business judgment rule, a stockholder-approved plan does not need to be "self-executing." That is, stockholders were not required to approve any specific grant types or amounts payable to a director. Rather, the board can exercise its discretion to make grants within the limits of the plan.

Second, the court distinguished between plans "with broad parameters and 'generic' limits applicable to all plan beneficiaries, on the one hand,"[2] and "a plan that sets 'specific limits on the compensation of the particular class of beneficiaries in question,'" on the other hand.[3] The latter plans, which must have limits

[1] C.A. No. 12327-VCS, mem. op. (Del. Ch. Apr. 5, 2017).
[2] *See, e.g., Sample v. Morgan*, 914 A.2d 647 (Del. Ch. 2007).
[3] *See, e.g., In re 3COM S'holders Litig.*, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999).

on “the magnitude of compensation to be paid to [] non-employee directors,” are sufficient to invoke the business judgment rule’s protection.

Third, the court found that the plan had sufficiently specific limits because it capped the aggregate number of awards that could be made to non-employee directors and further provided that the awards could be made in a single year or over the term of the plan. The court explained that “[o]nce the plan sets forth a specific limit on the total amount of options that may be granted under the plan to all directors, whether individually or collectively, it has specified the ‘director-specific ceilings’ ... found to be essential when determining whether stockholders also approved in advance the specific awards that were subsequently made under the plan.” Of note, the court did not require the plan to limit the number of awards on a per-director basis or an annual basis.

Finally, the court dismissed the plaintiffs’ disclosure challenges. In seeking stockholder approval of the plan, the proxy statement disclosed, among other things, (i) the total number of restricted shares that could be awarded; (ii) the total number of stock options that could be awarded; (iii) “the magnitude of the awards Board members could award to themselves”—including a limit for non-employee directors as a class equal to 30% of the authorized shares under the plan; and (iv) that all of the grants to non-employee directors could be made during any calendar year.[4] The court also rejected the plaintiffs’ claim that the board had failed to disclose its intent to promptly grant themselves significant equity awards as soon as stockholders approved the plan.

The court observed that the allegations in the complaint indicated “the awards here were quite large” and the directors “knew that the compensation they were awarding to themselves was well above the level of compensation of directors at other corporations in the Company’s self-identified peer group.” Nevertheless, the court declined to assess the reasonableness of the plan’s limits.

The court concluded that, because the plan had specific limitations on the directors’ compensation and had been approved by fully informed stockholders, the board’s subsequent decision to grant awards to the directors was protected by the business judgment rule, and the complaint was dismissed.

Take-Aways

A board’s decision to compensate its directors is an “interested” transaction.[5] For several reasons, however, challenges to director compensation are relatively infrequent. In particular:

- director compensation is often within an established range relative to peer companies and, therefore, unlikely to invite scrutiny;
- equity compensation serves an important objective of better aligning the interests of directors and stockholders;
- the amount of director compensation is often immaterial relative to the company, and thus the plaintiffs’ bar usually has limited incentive to bring suit; and
- as evidenced in *Investors Bancorp*, compensation under stockholder-approved plans will usually be protected by the business judgment.

[4] The court also rejected the plaintiffs’ argument that stockholder approval only protected a board’s decision under a director-only compensation plan. The court found it irrelevant that the plan also allowed for equity awards to officers and employees.

[5] Delaware law specifically authorizes the board of directors to compensate its members (8 *Del. C.* § 141(h) (“Unless otherwise restricted by the certificate of incorporation or bylaws, the board of directors shall have the authority to fix the compensation of directors.”), but Delaware courts can still review the board’s action for compliance with fiduciary duties.

Nevertheless, stockholders may challenge director compensation, particularly where the awards appear extraordinary.

Companies should focus on the limits set forth in their equity compensation plans to ward off stockholder challenges and insulate the board's decisions. As noted above, stockholder approval of a plan with appropriate limits will invoke the business judgment rule's protection for subsequent grant decisions within the authority conferred by the plan.[6] *Investors Bancorp* approved of an aggregate cap on awards that could be made to a *class of recipients*—i.e., non-employee directors. The court did not require an individual cap, nor did it require an annual cap. In fact, the plan expressly permitted all of the allotted non-employee director awards to be made "in any calendar year."

Investors Bancorp can be contrasted with the Court of Chancery's 2012 decision in *Seinfeld v. Slager*.[7] The plan at issue in *Seinfeld* had an individual (i.e., per director) award limit based on the number, rather than the value, of the awards. Because of the stock's then-trading price, this theoretically would have permitted each director to receive approximately $30 million in awards each year—although no such awards were actually granted. The *Seinfeld* court found that the plan "lacked sufficient definition" to invoke the business judgment rule's protection. It explained that under the *3COM* decision (on which *Investors Bancorp* similarly relied):

> there must be some meaningful limit imposed by the stockholders on the Board for the plan to be consecrated by *3COM* and receive the blessing of the business judgment rule, else the "sufficiently defined terms" language of *3COM* is rendered toothless. A stockholder-approved *carte blanche* to the directors is insufficient. The more definite a plan, the more likely that a board's compensation decision will be labeled disinterested and qualify for protection under the business judgment rule. If a board is free to use its absolute discretion under even a stockholder-approved plan, with little guidance as to the *total* pay that can be awarded, a board will ultimately have to show that the transaction is entirely fair.

Investors Bancorp did not cite to *Seinfeld*. In addition, in a footnote *Investors Bancorp* specifically rejected "Plaintiffs' proffered 'meaningful limits' test." The court said such an inquiry "would propel the court into a position where it was second-guessing the informed decision of stockholders." *Investors Bancorp* may signal a more deferential judicial approach to these matters. Still, boards of directors should give thoughtful consideration, aided by outside compensation consultants and legal counsel, in crafting equity compensation plans and obtaining stockholder approval to make sure they can withstand a stockholder lawsuit.

Contact

Steven M. Haas
shaas@hunton.com

[6] *See also Steiner v. Meyerson*, 1995 WL 441999 (Del. Ch. July 19, 1995) (dismissing challenge to stockholder-approved plan that granted directors options to purchase 25,000 shares upon election and an additional 10,000 shares on each anniversary of their election); *Cambridge Ret. Sys. v. Bosnjak*, 2014 WL 2930869, at *8 (Del. Ch. June 26, 2014) (dismissing challenge where the company's "stockholders approved the grant of up to 100,000 options to two of the Company's outside directors and, in 2011, approved the grant of up to 45,000 stock-based awards to six of the Company's outside directors").

[7] 2012 WL 2501105 (Del. Ch. June 29, 2012).