Client Alert

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Outside Director Compensation: Delaware Supreme Court Increases Scrutiny of Director Equity Awards

Due to a recent Delaware Supreme Court decision, boards of directors that set their own compensation may face increased judicial scrutiny. While previous courts have applied the protections of the business judgment rule to director equity awards that fall within the parameters of stockholder-approved equity incentive plans, the Supreme Court adopted a more narrow application of those protections with its recent ruling in *Investors Bancorp*. Specifically, the court held that the business judgment rule will only apply if stockholders approved (i) the specific equity awards made to the directors or (ii) a self-executing equity compensation plan. Otherwise, discretionary grants of equity awards to directors will be reviewed under the heightened "entire fairness" standard. This ruling will likely cause companies to rethink the terms of future equity plans. And for boards making discretionary director compensation decisions, they should work closely with outside advisors to help establish the fairness of the compensation.

Background

In *In re Investors Bancorp, Inc. Stockholder Litigation*, stockholders of Investors Bancorp, Inc., a publicly traded bank holding company, challenged equity awards the company's directors made to themselves.[1] While stockholders had approved the underlying equity incentive plan, the plan did not set forth specific grants to individual directors. Instead, it reserved a specific number of common shares for distribution to the company's officers, employees, non-employee directors, and service providers in the form of restricted stock awards, restricted stock units, and stock options. The plan limited the number of aggregate awards to non-employee directors to 30% of all awards granted under the plan and allowed those awards to all be granted in any calendar year. In 2015, the board awarded itself roughly $51.6 million in the aggregate in the form of restricted shares and stock options, an amount which the plaintiffs alleged was "inordinately higher than peer companies."

The Court's Analysis

Under prior Court of Chancery decisions, director compensation decisions would be reviewed under the business judgment rule if made pursuant to a stockholder-approved equity plan that imposed "meaningful limits" on the directors' discretion.[2] In that case, stockholder approval served to ratify the board's subsequent grant decisions, although there was sometimes uncertainty as to whether a plan's parameters were sufficiently meaningful to limit judicial review. If, however, the director compensation was not made under a stockholder-approved plan or was made under a stockholder-approved plan that did not have "meaningful limits" on the board's discretion, the courts would apply the entire fairness test.

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[1] 2017 WL 6374741 (Del. Dec. 13, 2017).

[2] Compare *In re 3Com Corp. S'holders Litig.*, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999) (applying the business judgment rule to self-authorized director grants that fell within the limits of a shareholder-approved equity incentive plan), with *Seinfeld v. Slager*, 2012 WL 2501105 (Del. Ch. June 29, 2012) (holding "entire fairness" was the correct standard for board action under stockholder-approved equity plans that allow director discretion in granting awards) and *Calma v. Templeton*, 114 A.3d 563 (Del. Ch. 2015) (applying entire fairness to director grants under a plan that contained only generic limits).

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This is because the courts have viewed a board's decision to establish its directors' compensation as a conflict of interest transaction.

Dispensing with the "meaningful limits" test, the Supreme Court in *Investors Bancorp* held that in reviewing *discretionary* decisions of directors under stockholder-approved equity incentive plans, the entire fairness standard must apply. It further held that stockholder approval of an equity incentive plan will not impart the presumption of the business judgment rule on director awards unless (i) the stockholders approved the specific awards or (ii) the plan was self-executing. The court reasoned that stockholder approval of the general guidelines of an equity incentive plan only provides boards with the *legal* authority to make awards, but does not absolve the board of its fiduciary duties in making such awards. The court held that "director action is 'twice-tested,' first for legal authorization, and second by equity."

Applying these principles to the case, the Supreme Court held that the plaintiff had adequately alleged a breach of fiduciary duty against the company's directors. Among other things, the Supreme Court noted that the compensatory awards were allegedly "excessive" when compared both to the company's historical practices and to its peers.

Considerations Moving Forward

Stockholder challenges to board compensation are uncommon.[3] However, given the court's decision in *Investors*, the risk to boards that use their discretion to grant compensation to directors has increased, even if they are acting within parameters set by stockholder-approved equity incentive plans. It is too early to tell whether more lawsuits will be brought challenging discretionary director compensation. Lawsuits are most likely to be brought when there are unusual circumstances or compensation that seems plainly excessive. It is unlikely, however, that *Investors* significantly raises the prospects for personal liability of directors making compensatory awards within typical ranges of director compensation.

For companies adopting new director compensation plans, the clearest way for boards to receive the protections of the business judgment rule when making director compensation decisions is to take advantage of the "safe harbor" created by *Investors*. This means obtaining stockholder approval of (i) the specific director awards or (ii) a self-executing equity incentive plan. Compensation consultants will surely be considering the pros and cons of this approach. Some companies may also decide to amend existing plans to fall within the *Investors* framework. A self-executing plan could specify the awards that will be made on particular dates or set forth a formulaic plan. It is not clear whether plans that impose a small amount of discretion would trigger entire fairness (e.g., a plan that capped the annual value of individual awards but gave the board discretion to reduce the awards). In addition, boards that make unusually large compensation grants to directors may want to consider obtaining stockholder approval before the grants are made.

For boards that cannot, or choose not to, act within those parameters, they should consider how best to establish the fairness of their compensation decisions. Entire fairness looks at a variety of factors, including the process, timing, structure, disclosure, and price pertaining to the challenged transaction. For example, courts may examine the following factors:

- the value of the grants on a stand-alone basis;
- whether the grants deviated materially from the company's historical practices;

[3] Reasons for the infrequency of such challenges include established ranges of compensation for various peer groups that inform directors as to acceptable compensation amounts and the relative immaterially of most director compensation relative to the company's value, limiting the incentive for the plaintiff's bar to bring suit.

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- consideration of peer group data;
- whether the grants were nevertheless made pursuant to reasonable limits in a stockholder-approved plan;
- the sufficiency of the disclosure when stockholder approval was sought;
- the number of meetings of the board of directors or its applicable committee overseeing director compensation and that quality of the materials that were considered;
- the timing of the grants;
- the extent to which the equity awards were structured to align the interests of the directors and stockholders; and
- whether an outside compensation consultant advised the board or its applicable committee.

It may also be helpful for the board to separate the processes for granting equity to outside directors and executive directors.

In determining whether to seek stockholder approval of specific director compensation awards, public companies must weigh the benefits of the business judgment rule against the disadvantages of decreased flexibility in altering director compensation as needed and increased disclosure to stockholders about the equity plans and amendments. In making this determination, companies should also consider their director compensation relative to peer companies, understanding that director awards that exceed those of similarly sized or performing companies may invite scrutiny from the plaintiffs' bar.

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