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Discretionary Director Compensation Subject to Entire Fairness Review

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On December 13, 2017, on appeal from the Chancery Court, the Delaware Supreme Court in In re Investors Bancorp, Inc. Stockholder Litigation, Del. Supr., No. 169, 2017, Strine, C.J. (Dec. 13, 2017) ("***Bancorp***"), denied a motion to dismiss a breach of fiduciary duty claim brought by shareholders of Investors Bancorp, Inc. ("***Investors Bancorp***") and held that director equity grants based on director discretion are subject to an "entire fairness" standard of review.

The case represents a move away from the "meaningful limits" standard set out in In re 3COM Corp., Del. Ch., No. 16721, Steele, V.C. (Oct. 25, 1999) ("***3COM***"), Calma v. Templeton, Del. Supr., 114 A.3d 563 (2015) ("***Calma***") and Seinfeld v. Slager, Del. Ch., No. 6462-VCG, Glasscock, V.C. (June 29, 2012) ("***Seinfeld***") and originally upheld by the Delaware Court of Chancery in In re Investors Bancorp, Inc. Stockholder Litigation, No. 12327-VCS, Slights, V.C. (Apr. 5, 2017).

The Issue

Board decisions regarding compensation are normally protected by the "business judgment rule," pursuant to which a court will generally defer to the decisions of the directors. However, in order to have the protection of the "business judgment rule," directors must be both independent and disinterested with respect to the decision being made (which they clearly are not when the decision pertains to their own compensation). If the business judgment rule does not apply, a court will review the facts surrounding the decision and reach its own conclusions under the "entire fairness" test, which requires that the directors prove their compensation decision was entirely fair to the corporation. Such claims will more likely proceed beyond the summary judgement phase since they require a review of the facts surrounding the compensation decision, unless the board can argue that the "shareholder ratification" defense applies.

The "shareholder ratification" defense is a defense that has developed under Delaware case law and provides that if shareholders approve a board decision, then any subsequent shareholder challenge must prove that the decision amounted to corporate waste (a very high standard). If the "shareholder ratification" defense applies, there is a much stronger likelihood of defeating such shareholder strike suit claims at the summary judgment phase.

Recent case law has focused on the question of what exactly shareholders must approve in order for a company to avail itself of the "shareholder ratification" defense. In *3COM, Seinfeld and Calma*, the courts adopted a "meaningful limits" standard for this purpose (i.e. the shareholder ratification defense will be available where the shareholders have approved "meaningful limits" on director compensation). As a result of these decisions, in order to use the "shareholder ratification" defense, many companies have in the last 3-5 years, adopted director equity incentive plans (separate from their general omnibus equity incentive plan for employees and/or other service providers) that contain general limits on non-employee director awards applicable to all non-employee directors and had the plans containing the general director limits separately approved by shareholders. The *Bancorp* decision has provided new insight on whether this approach will have the desired effect.

Background to the Case

In June of 2015, *Investors Bancorp's* shareholders approved an omnibus equity incentive plan that allowed grants of equity awards to *Investors Bancorp's* officers, employees, non-employee directors and service providers. The equity plan included a specific limit on all non-employee director awards of up to 30% of the shares available for option and restricted stock awards issuable under the plan, all of which could be granted in any calendar year. The plan neither contained specific limits applicable to individual directors nor imposed any other limits on grants to directors and it gave the non-employee directors the discretion to grant significant awards to themselves in any calendar year.

Subsequent to the equity plan's approval, the compensation committee of the board approved significant awards of restricted stock and stock options to all of the company's board members in a single year following completion of a mutual-to-stock conversion, which was out of line with peer practice and far larger than previous awards. The fair value of all the director awards granted within the 30% pool totaled approximately $51.65 million having an average value of approximately $2.16 million for each non-employee director and included award grants to the company's chief executive officer and chief operating officer valued at over $16 million and $13 million, respectively. The value of those awards was substantially higher than the value of awards which were provided to directors of corporations in *Investors Bancorp's* peer group. Shortly after the awards were announced in April of 2016, shareholders of the company filed three separate complaints in the Delaware Court of Chancery "alleging breaches of fiduciary duty by the directors for awarding themselves excessive compensation."

In April of 2017, keeping with *3COM, Seinfeld and Calma*, the Delaware Court of Chancery determined that the 30% cap on awards to all directors served as a "meaningful limit" on director awards and granted *Investors Bancorp's* motion to dismiss the shareholder challenge of the awards based on the "shareholder ratification" defense. In its December 13, 2017 decision, the Delaware Supreme Court reversed the Court of Chancery's decision, holding that the discretion non-employee directors were allowed under the *Investors Bancorp* equity plan to approve specific awards to non-employee directors precluded the "shareholder ratification" defense. According to the Delaware Supreme Court, "when stockholders have approved an equity incentive plan that gives the directors discretion to grant themselves awards within general parameters, and a stockholder properly alleges that the directors inequitably exercised that discretion, then the [shareholder] ratification defense is unavailable to dismiss the suit, and the directors will be required to prove the fairness of the awards to the corporation."

Standard of Review

Following the *Bancorp* decision, director awards must be reviewed under the "entire fairness" standard, unless the (i) incentive compensation plan is self-executing, whereby the equity plan does not require director action or discretion to implement earned awards, or (ii) shareholders approve specific compensation awards to the company's individual directors under the plan. As such, awards issued to directors under a discretionary, shareholder-approved equity incentive plan that contains general aggregate limits on director compensation are at risk of future shareholder challenges that will likely survive the summary judgment/motion to dismiss phase of such cases.

In Summary

After the *3COM, Seinfeld and Calma* decisions, many companies have taken the approach of adopting two equity incentive plans – one for non-employee directors and one for employees – instead of one plan covering both groups of participants. Following the recent *Bancorp* decision, we would recommend that companies continue with this two plan approach to help insulate at least the employee equity plan from the risk of a shareholder challenge that is subject to an "entire fairness" standard of review. While it may be possible to successfully argue that the "shareholder ratification" defense applies to director awards granted under a single non-employee director and employee plan that includes specific director limits or includes self-executing director grants, it is not worth the risk of a challenge that other aspects of the plan introduce director discretion and thereby limit the "shareholder ratification" defense. In addition, although the two plan approach requires the shareholders to approve two separate equity plans, it also provides a distinctive framework for director compensation to help ensure efficient administration of director compensation, makes proxy disclosure regarding director compensation clearer, and provides an easier route to more frequent shareholder ratification, if desired, where specific award limits or self-executing grants are amended year-to-year without the need to subject the broad-based (employee) equity plan to shareholder approval and the accompanying shareholder advisory service scrutiny.

Public companies should continue to implement usual good corporate governance policies, including ongoing review of director compensation limits against those of peer companies, proper documentation of compensation decisions, and appropriate disclosure of the process and the director compensation granted in the company's proxy and/or other public filings (and while the case law noted above deals with equity awards, the same process arguably should be applied to director cash compensation).

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