Simpson Thacher

Memorandum

Director Compensation Revisited in Light of *Investors Bancorp* Decision

January 25, 2018

The Delaware Supreme Court's recent decision in *In re Investors Bancorp, Inc. Stockholder Litigation* raises new questions regarding the appropriate standard of review in cases challenging director compensation levels. As we have previously noted in our Client Alert dated May 27, 2015, several Delaware Court of Chancery cases in recent years have suggested that the inclusion in a shareholder-approved equity incentive plan of "meaningful limits" on director compensation may help shield directors under the more deferential "business judgment" standard of review, rather than the "entire fairness" standard, in the event of plaintiffs' challenges to director compensation levels. The new *Investors Bancorp* decision suggests that "meaningful limits" under a shareholder-approved plan may not suffice for purposes of securing the "business judgment" standard. The attached multi-firm memo discusses this new case and possible approaches for companies to consider in light of the case.

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NEW YEAR'S RESOLUTIONS FOR DIRECTOR COMPENSATION FROM *INVESTORS BANCORP*

January 25, 2018

In recent years, shareholder plaintiffs have brought a series of claims before the Delaware Court of Chancery alleging that directors of Delaware companies have abused their discretion in granting themselves excessive equity compensation for their board service. These cases raised the threshold question of whether the plaintiffs' challenges should be reviewed under the "entire fairness" standard, which requires the company to bear the burden of proving that the director awards were fair, or the more deferential "business judgment" standard, which grants considerable discretion to directors' decisions, often resulting in dismissal of claims that fail to plead particularized facts indicating fiduciary lapses by the directors.

In the motion practice surrounding these cases, the Court of Chancery has suggested that if a company's equity incentive plan contained "meaningful limits" on director awards and the plan were approved by shareholders, subsequent challenges to director awards within these limits were entitled to "business judgment" deference. In response to these cases, a number of companies amended their equity plans to include a shareholder-approved limit on director awards, typically expressed as an annual limit.

A recent decision by the Delaware Supreme Court raises a question as to whether a plan limit allowing board discretion to grant awards within general parameters will be sufficient to ensure business judgment deference, rather than an entire fairness review. In *In re Investors Bancorp, Inc. Stockholder Litigation*, although the Supreme Court did not specifically reject the Court of Chancery's "meaningful limit" exception, it strongly suggested that even where a plan includes a shareholder-approved limit on director awards, challenges to those awards might warrant review under the "entire fairness" standard if (1) the plan leaves the directors discretion to determine their own awards within the limit and (2) a plaintiff can plead facts sufficient to show a possible breach of fiduciary duties.[1]

It is not entirely clear whether the Supreme Court intended to deny business judgment deference to any plan under which directors had discretion to determine their own awards, subject to a plan limit, or if it merely saw the plan limit and the facts of *Investors Bancorp* as being outside the "meaningful limit" comfort zone. The facts in of *Investors Bancorp* were indeed on the fringe:

- the plan limit was an aggregate, rather than an annual, limit;
- the limit was quite high;
- the awards in question were special one-time awards which were quite large in comparison to the normalized awards historically granted to directors at the company and at peer companies; and
- there were questions about what shareholders understood when they approved the plan limit.

Against this background, the Supreme Court ruled that the plaintiffs had pleaded facts leading to an inference that the awards were "unfair and excessive" and remanded the case to the Court of Chancery for an entire fairness review.[2] However, the Supreme Court's ruling did not tie its reasoning and decision to any of the

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[1] *In re Investors Bancorp, Inc. Stockholder Litig.*, A.3d, 2017 WL 6374741 (Del. Dec. 13, 2017).

[2] Page 31.

specific facts of the case, but instead went directly to basic principles, stating that when shareholders approve the general parameters of an equity compensation plan and allow directors to exercise their broad authority under that plan, "the directors' exercise of that authority must be done consistent with their fiduciary duties"[3] and citing the longstanding principle that "inequitable action does not become permissible simply because it is legally possible."[4]

Clearly, director awards conforming to a specific amount or formula will be protected. Although the *Investors Bancorp* decision limits the value of a shareholder-approved limit that does not include a specific amount or formula for director awards, the recent cases still leave the impression that a reasonable shareholder-approved maximum limit, together with good board process in determining director awards within that limit, should place a board's grant decision within the business judgment standard. That interpretation suggests the following questions:

- What type of range or maximum limit might be sufficient to retain a board's business judgment deference, and is this maximum workable enough, and are the odds of deference certain enough, to make it worthwhile to go through the trouble of obtaining shareholder approval?
- If a company does decide to obtain shareholder approval of a maximum limit, should the limit apply to both director equity awards and cash compensation to improve the probability of obtaining deference?
- With or without a limit, what other measures should a board take in setting director compensation to establish a defense that either supports business judgement deference or creates a record that eliminates a plaintiff's ability to make a sustainable pleading of potential fiduciary breach?

In light of *Investors Bancorp*, here are a few resolutions for your board of directors to consider in connection with a director compensation plan:

- Although there is reason to hope that a sensible maximum limit would offer a meaningful advantage in the event of a challenge, the *Investors' Bancorp* decision gives practitioners reason to pause. Accordingly, for companies that have not yet sought shareholder approval of directors' compensation and were not inclined to do so this year, *Investors' Bancorp* does not provide any rationale for a change of heart.
- Companies that have obtained shareholder approval of reasonable maximum annual limits on director ***equity*** awards unfortunately cannot assume that this will assure business judgement deference. However, assuming that a reasonable limit was adopted, *Investors Bancorp* offers no specific guidance to revisit the limit in the near term, and it would presumably be impractical to rush back to shareholders with a change to the limit. Accordingly, we recommend not doing so unless there are other reasons to bring the directors' equity plan to shareholders.
- Further, if a company has obtained shareholder approval for a reasonable equity award limit, the question arises as to whether it should also obtain approval for a cash limit. In our view, there is not enough guidance or certainty to warrant returning to shareholders for a cash limit at this time. We think that a board could reasonably decide to defer action until the law is clarified, particularly if the company's equity plans are not being brought to shareholders.
- Of course, a board could ask shareholders to approve a specific annual director compensation formula. The board would need to accept that the formula might have limited benefit if it did not cover both equity and cash, which would be novel for a fixed formula approach. However, it is not at all clear that a formula approach is warranted at this point.

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[3] Page 26 – (citing *Sample v. Morgan*, 914 A.2d 647 (Del. Ch. 2007)).

[4] Page 27 – (citing *Schnell v. Chris-Craft Ind., Inc.*, 285 A.2d 487, 489 (Del. 1971)).

- Regardless of the presence or scope of an equity plan limit, we recommend that the following should be considered in order to minimize the litigation risk arising from *Investors Bancorp*:
    - If a company is going to put a maximum limit to shareholder approval, include more specific and tighter limits on the amounts of cash and equity compensation that each director may be awarded annually pursuant to plans submitted for shareholder approval. Tighter limits that minimize discretion will help to mitigate the risk of nuisance litigation.
    - Most importantly, enhance the frequency and rigor of the board's consultation with a compensation consultant to determine the appropriate amount of director cash and equity compensation. Evidence showing that director compensation levels, including equity awards, are generally consistent with peer levels, including an annual benchmarking survey, may be helpful to show that those decisions were reasonable and entirely fair. Be mindful of the peer set used. Plaintiffs frequently criticize boards' choice of peers.
    - Separate executive compensation decisions from director compensation decisions, and mitigate other factors that could suggest a lack of disinterestedness. In *Investors Bancorp*, the Supreme Court determined that demand was excused, because it was "implausible to [the court] that the non-employee directors could independently consider a demand when to do so would require those directors to call into question the grants they made to themselves."[5] Boards should consider granting director and executive awards under separate plans. Boards should also consider delegating director compensation decisions to the Nominating and Governance Committee, rather than have those decisions be approved by the Compensation Committee or all of the non-executive members of the board.[6]
    - Document the decision carefully. The Delaware courts have repeatedly emphasized "the importance of process in satisfying fiduciary duties when evaluating and approving executive compensation packages."[7] While board committees typically, and understandably, default to a "less is more" approach in capturing deliberation in their minutes, this might be an area where a bit more is warranted. For example, if a company's director compensation is in the upper percentile of its peer study, consider having the record reflect a brief statement of the rationale. Consider disclosing in the annual proxy statement information regarding the rationale behind director compensation decisions and each element of director compensation.

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[5] Page 32

[6] A recent opinion in the New York state courts also suggests the importance of separating the director and executive compensation decisions and of limiting the number of directors involved in the approval of director compensation, for demand futility purposes. See *Cement Masons Local 780 Pension Fund v Schleifer*, 2017 N.Y. Misc. LEXIS 2554 (June 28, 2017).

[7] Delaware Court of Chancery Offers Practical Lessons for Compensation Committees, Cleary M&A and Corporate Governance Watch, https://www.clearymawatch.com/2016/03/delaware-court-of-chancery-offers-practical-lessons-for-compensation-committees/

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