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INVESTORS BANCORP: STRUCTURING AND APPROVING NON-EXECUTIVE DIRECTOR COMPENSATION TO AVOID JUDICIAL REVIEW

In the recent Investors Bancorp *case, the Delaware Supreme Court clarified that advance stockholder approval of a compensation plan may only "ratify" future grants if the plan is self-executing, i.e., it left the board with no discretion, and enumerated specific grants or a formula for calculating specific grants. The authors discuss the case and, in light of it, suggest steps in structuring and approving plans that directors may take to avoid protracted stockholder litigation.*

By Michael D. Allen and Robert B. Greco *

In most cases, decisions regarding non-executive director compensation will be inherently conflicted such that, if challenged under Delaware law, the directors will bear the burden of proving that their compensation was "entirely fair" under the exacting entire fairness standard. Prior to the Delaware Supreme Court's ruling in *In re Investors Bancorp, Inc. Stockholder Litigation*,[1] several opinions of the Delaware Court of Chancery indicated that such decisions could instead be reviewed under the deferential business judgment rule if a grant is made under a stockholder-approved compensation plan with "meaningful limits" on the awards that could be granted to directors.[2] In *Investors Bancorp*, the Court of Chancery followed these decisions and dismissed challenges to director compensation grants under a discretionary stockholder-approved equity incentive plan with limits the court deemed meaningful.[3] On appeal, however, the Supreme Court reversed the Court of Chancery's decision and the line of cases on which it relied, clarifying that advance stockholder approval of compensation plans may only "ratify" future grants if the plan is self-executing. In light of this decision, boards of public Delaware corporations without self-executing

[1] 177 A.3d 1208 (Del. 2017).

[2] *See, e.g.*, *In re 3COM Corp. S'holders Litig.*, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999); *Seinfeld v. Slager*, 2012 WL 2501105

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(Del. Ch. June 29, 2012); *Calma v. Templeton*, 114 A.3d 563 (Del. Ch. 2015).

[3] 2017 WL 1277672 (Del. Ch. Apr. 5, 2017), *rev'd*, 177 A.3d 1208.

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plans may wish to reconsider their compensation arrangements in order to avoid or help defend against stockholder derivative lawsuits.

JUDICIAL REVIEW OF DIRECTOR COMPENSATION DECISIONS UNDER DELAWARE LAW

Delaware's General Corporation Law expressly empowers boards to fix director compensation.[4] But, like all board decisions, decisions on director compensation must be made in accordance with the board's fiduciary duties.[5]

Decisions regarding director compensation will typically be analyzed under one of two standards of review — the business judgment rule or entire fairness.[6] While the business judgment rule initially attaches to most board decisions, its presumptions may be rebutted if, *inter alia*, the decision is not approved by a majority of directors who are independent and disinterested.[7] The applicable standard of review is "often of critical importance."[8] Where the business judgment rule applies, a court will not substitute its judgment for that of the board if the decision "can be attributed to any rational business purpose."[9] By contrast, if the presumptions of the business judgment rule are rebutted, the decision will be reviewed under the entire fairness standard, and the directors will bear the burden of proving that the challenged decision was entirely fair (both in terms of price and process) to the corporation and its stockholders. As this inquiry is fact intensive, application of the entire fairness standard will normally prevent the dismissal of a lawsuit on a motion to dismiss[10] and, as a result, could lead to prolonged litigation or dramatically increase a claim's settlement value.

Decisions regarding non-executive director compensation, traditionally made by compensation committees consisting solely of non-executive directors, will often be subject to the entire fairness standard. Under the doctrine of ratification, however, decisions that may otherwise be subject to heightened scrutiny can, in most cases,[11] receive the protections of the business judgment rule if they are approved by a majority vote of fully informed, uncoerced, and disinterested stockholders.[12]

Initially, this doctrine was applied to stockholder-approved compensation plans that were "self-executing" — *i.e.*, those that left the board with no discretion and enumerated specific grants (or a formula for calculating specific grants) made, or to be made, in the future.[13]

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[4] 8 *Del. C.* § 141(h).

[5] *See generally Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971); *see also Cambridge Ret. Sys. v. Bosnjak*, 2014 WL 2930869, at *6 (Del. Ch. June 26, 2014) ("On its face, § 141(h) only speaks to the authority of directors to set their own compensation. It does not address the standard of review applicable to such a decision."); *Calma*, 114 A.3d at 576 n.45 ("Section 141(h) of the Delaware General Corporation Law is a grant of authority for directors to set their compensation, not a statutory safe harbor mandating the business judgment standard of review for director compensation decisions.").

[6] The third standard of review, enhanced scrutiny, is most frequently invoked in connection with change-of -control transactions, the adoption of defensive measures, or action taken for the purpose of impeding the stockholder franchise. *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457–59 (Del. Ch. 2011).

[7] *Larkin v. Shah*, 2016 WL 4485447, at *8 (Del. Ch. Aug. 25, 2016).

[8] *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1116 (Del. 1994) (quoting *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993)).

[9] *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

[10] *Orman v. Cullman*, 794 A.2d 5, 21 n.36 (Del. Ch. 2002).

[11] For the business judgment rule to apply to transactions with a conflicted controlling stockholder, they must be conditioned on the approval of both a disinterested special committee and a majority of the corporation's disinterested stockholders at the outset of negotiations. *Kahn v. M & F Worldwide Corp.*, 88 A.3d 625 (Del. 2014); *Ira Trust FBO Bobbie Ahmed v. Crane*, 2017 WL 7053964 (Del. Ch. Dec. 11, 2017).

[12] *Investors Bancorp*, 177 A.3d at 1211.

[13] *See, e.g., Kerbs v. Cal. E. Airways, Inc.*, 90 A.2d 652 (Del. 1952); *Gottlieb v. Heyden Chemical Corp.*, 91 A.2d 57 (Del. 1952); *Steiner v. Meyerson*, 1995 WL 441999 (Del. Ch. July 19, 1995); *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997).

Subsequently, in cases such as *In re 3COM Corp. Shareholders Litigation*[14] and *Calma v. Templeton*,[15] the Court of Chancery indicated that stockholder approval of compensation plans that were not self-executing and vested directors with some discretion on future compensations decisions could preclude judicial review of such future decisions so long as the plan contained "meaningful limits" on the compensation that the directors could award themselves.[16]

INVESTORS BANCORP AND THE LIMITS OF RATIFICATION

Investors Bancorp involved a challenge to 2014 and 2015 compensation grants to the members of the board of directors (the "Board") of Investors Bancorp, Inc. (the "Company"), which was comprised of 10 non-employee directors and two executive directors.[17] The compensation decisions were made by the Company's compensation committee (the "Committee"), which consisted of seven of the 10 non-employee directors.[18]

In 2014, the Committee approved cash compensation to the non-employee directors ranging from $97,200 to $207,005 per director and compensation packages to the executive directors valued at $2,778,700 and $1,665,794, respectively.[19] In December 2014, the Committee approved 2015 compensation packages for the directors generally in line with those given in 2014.[20]

Three months later, the Board decided to revisit director compensation and ultimately adopted the Company's 2015 Equity Incentive Plan (the "Plan").[21] Nearly 31 million shares of the Company's common stock were reserved for issuance under the Plan, which authorized the grant of restricted stock awards, restricted stock units, and stock options to the Company's officers, employees, non-employee directors, and service providers.[22] Among other limitations, the Plan provided that only 4,411,613 shares could be issued to any individual employee through the exercise of stock options and only 3,308,710 shares could be issued to any individual employee as restricted stock or a restricted stock unit grant.[23] The Plan further provided that only 30% of the option and restricted stock shares available thereunder could be issued to the non-employee directors in the aggregate, but allowed all such grants to be made in any calendar year.[24] The Plan was submitted to the Company's stockholders at its 2015 annual meeting and approved by the holders of over 96% of the shares that voted and over 79% of the Company's outstanding stock.[25]

During the following two weeks, the Committee met on several occasions and ultimately granted restricted stock and stock options with an aggregate value of approximately $51.5 million to the 12 directors.[26] The two executive directors received grants worth nearly $16.7 million and $13.4 million, respectively; the chairman and lead director each received grants valued at more than $2.6 million; and the remaining non-employee directors were each awarded grants valued at more than $2 million.[27] Following the public announcement of these awards, three separate complaints were filed alleging that the directors breached their fiduciary duties in awarding these grants.[28] The defendants moved to dismiss, arguing that stockholder approval of the Plan "ratified" the challenged grants made thereunder.[29] In addition, the defendants sought to dismiss the claims challenging the awards to the executive directors on the basis that no demand was made prior to the commencement of the litigation.[30]

The plaintiffs sought to overcome the defendants' ratification defense by arguing, *inter alia*, that the awards could not be ratified absent stockholder approval of each specific grant because the Plan was not self-executing and contained no "meaningful limits" on the awards the directors could grant to themselves.[31] Ruling

[14] 1999 WL 1009210.

[15] 114 A.3d 563.

[16] *Id.* at 585 (quoting *Seinfeld*, 2012 WL 2501105, at *12).

[17] 2017 WL 1277672, at *3.

[18] *Id.*

[19] *Id.*

[20] *Id.* at *3–4.

[21] *Id.* at *4.

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.* at *5.

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *Id.* at *6.

on the defendants' motion to dismiss, the Court of Chancery found that the Plan "contained meaningful, specific limits on awards to all director beneficiaries."[32] As a result, the Court of Chancery, relying on *3COM* and *Calma*, held that stockholder approval of the Plan ratified the awards and precluded further judicial review.

The Court of Chancery further held that the plaintiffs' failure to make a pre-litigation demand mandated dismissal of the claims relating to the awards granted to the executive directors. Although the non-employee directors, who constituted more than a majority of the Board, had no direct interest in these awards, the plaintiffs argued that demand was futile because the awards granted to the executive directors "were part of a premeditated unitary transaction with a single purpose: to allocate shares to executive and non-executive members of the Board, *i.e.*, a *quid pro quo*."[33] The Court of Chancery rejected this argument, noting that the plaintiffs' *quid pro quo* theory could only carry weight if the non-employee directors received something in return for approving the grants to the executive directors.[34] As the awards received by the non-employee directors fell within the parameters of the stockholder-approved Plan, the Court found that the non-employee directors received nothing in exchange for approving the awards to the executive directors.[35] Finding no reason to question the independence or disinterestedness of a majority of the Board, the Court of Chancery dismissed the claims challenging the executive director grants.[36]

On appeal, the Supreme Court reversed these rulings, holding that stockholder approval of compensation plans vesting directors with discretion does not necessarily vest subsequent board decisions exercising such discretion with the protections of the business judgment rule. The Supreme Court reviewed precedent applying the doctrine of ratification to director compensation claims, beginning with its 1952 decisions in *Kerbs v. California Eastern Airways*[37] and *Gottlieb v. Heyden Chemical Corp*.[38] While the Supreme Court applied the doctrine of ratification in each of these cases, the compensation plan approved in *Kerbs* was self-executing and the plan at issue in *Gottlieb* set forth a schedule of the specific issuances to be granted thereunder.[39] Moreover, in *Gottlieb*, the Supreme Court held that options subject to certain future awards were not ratified because they "had not been placed into any contracts prior to approval," the stockholders only approved allocation of shares "of a certain general pattern," and "nobody knew what all of the terms of these future contracts would be."[40]

The Supreme Court noted that while the Court of Chancery initially applied the doctrine to self-executing plans, it began to expand the doctrine's application in cases such as *3COM*, where the plan left directors with discretion, but contained specific limits for awards, and *Criden v. Steinberg*,[41] where the plan allowed directors to re-price options after it had been approved by stockholders.[42] Then, in *Seinfeld v. Slager*, the Court of Chancery found that the awards granted under a stockholder-approved plan with only general parameters for future awards were not ratified and, in distinguishing the case from *3COM*, the *Seinfeld* Court first articulated the notion that "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."[43] This "meaningful limit" standard was then applied by the Court of Chancery in *Calma* and formed the basis of the trial court's holding in *Investors Bancorp*.

Despite these developments in the law at the trial court level, the Supreme Court had not had the opportunity to opine on the application of ratification to director compensation since its decisions in *Kerbs* and *Gottlieb*.[44] Finally having occasion to do so in *Investors Bancorp*, the Supreme Court rejected the "meaningful limit" test, holding that where stockholders have vested directors with discretion to grant themselves awards, such discretion must be exercised in accordance with their fiduciary duties.[45] The Court observed that stockholder approval of a discretionary plan differed from stockholder approval of a self-executing plan or of specific awards in that, in the latter two circumstances,

[32] *Id.* at *8.

[33] *Id.* at *11.

[34] *Id.*

[35] *Id.*

[36] *Id.* at *12.

[37] 90 A.2d 652.

[38] 91 A.2d 57.

[39] *Investors Bancorp*, 177 A.3d at 1218.

[40] *Id.* (quoting *Gottlieb*, 91 A.3d at 60).

[41] 2000 WL 354390 (Del. Ch. Mar. 23, 2000).

[42] *Investors Bancorp*, 177 A.3d at 1222.

[43] 2012 WL 2501105, at *12.

[44] *Investors Bancorp*, 177 A.3d at 1219.

[45] *Id.* at 1223.

"stockholders know precisely what they are approving."[46] Because the stockholders did not ratify, either prospectively or retroactively, the specific awards being challenged, the Supreme Court held that the directors were required to establish the fairness of the awards to the Company.[47]

Given that the executive director and non-employee director compensation grants were considered and approved at a series of nearly contemporaneous meetings, the Supreme Court further found it "implausible" that the non-employee directors could consider a demand regarding the executive director compensation, as doing so would require the non-employee directors to question the grants they had made to themselves.[48] Accordingly, the Supreme Court ruled that demand was excused for each of the compensation claims.[49]

STRUCTURING AND APPROVING DIRECTOR COMPENSATION FOLLOWING *INVESTORS BANCORP*

The Supreme Court's decision in *Investors Bancorp* indicates that interested compensation awards may only be ratified to avoid judicial scrutiny if they are specifically approved by the stockholders or made under a self-executing stockholder-approved plan. In light of this opinion, directors seeking to avoid stockholder claims challenging director compensation may consider whether to seek stockholder approval of plans providing for self-executing compensation awards to non-executive directors, or whether to seek stockholder approval of amendments to existing plans to include these provisions.

Self-executing plans may not, however, be necessary or appropriate in all cases. Some boards may determine it is appropriate to retain some level of discretion so that the corporation is better situated to attract and retain directors as circumstances change. Others may be wary of placing too much influence in the hands of proxy advisory firms such as ISS, which has recently increased its focus on non-executive director compensation,[50] as the board may find it difficult to justify awarding the level of compensation set forth in a self-executing plan if stockholders vote against it.

Additionally, while the certainty of ratification is undoubtedly beneficial, it may not always be necessary to avoid costly and prolonged litigation. Although the invocation of the entire fairness standard will almost always prevent the dismissal of a claim on a motion to dismiss, in at least one case the Court of Chancery dismissed claims challenging annual compensation to non-executive directors of a large public company ranging in value from $85,000 to $120,000 on a motion to dismiss, finding no reasonably conceivable set of circumstances based on the pled facts that this level of compensation for directors of a public corporation would fail the entire fairness test.[51] Moreover, even if "advance ratification" is not obtained, if a complaint is brought challenging specific compensation awards, ratification of such awards may be sought after the fact at the next annual meeting. If full disclosure is made regarding the specific grants and the effect of their approval on the pending litigation, and the stockholders vote to ratify the grants, the vote should effectively extinguish the claims.[52]

Nevertheless, directors adopting, or granting awards to non-executive directors under, discretionary plans should be mindful that the decision to grant awards to themselves under such plans will generally be subject to judicial review under the entire fairness standard, which requires them to establish the fairness of the value of the awards and the process used to grant them. Thus, directors should conduct a diligent decision-making process prior to making any compensation grants. As Section 141(e) of the General Corporation Law fully protects directors relying in good faith on professional advisors selected with reasonable care,[53] directors will

[46] *Id.* at 1222.

[47] *Id.* at 1225.

[48] *Id.* at 1225–26.

[49] *Id.* at 1226.

[50] *See* Institutional Shareholder Services Inc., *US Policy – Director Elections – Non-Employee Director Compensation*, *available at* https://www.issgovernance.com/file/policy/1-

footnote continued from previous column…

2017-comment-period-template-us-director-elections-ned-pay.pdf.

[51] *Oldfather v. Ells*, C.A. No. 12118-VCL (Del. Ch. Dec. 7, 2016) (transcript).

[52] If this approach is used, directors should proceed with caution and seek stockholder feedback prior to ultimately deciding whether to put the grants to a stockholder vote, since the failure to receive the required vote could be seen as an indication of unfairness in any lawsuit challenging the grants. In addition, if stockholder approval is obtained and the pending litigation is mooted, the plaintiff's attorney will likely seek a fee for causing the corporation to seek and obtain this approval.

[53] 8 *Del. C.* § 141(e).

also be well advised in engaging and relying on outside compensation consultants, counsel, and other advisors to assist in granting awards,[54] particularly in light of recent decisions of the Delaware courts highlighting the importance of Section 141(e).[55] In addition to relying on the advice of consultants, directors should consider the compensation paid to the directors of peer companies, which may help support the fairness of any compensation decisions.

Finally, it is important to note that compensation grants to executive directors — which are typically approved by compensation committees comprised of independent directors and therefore not subject to the entire fairness standard — will generally not need to be approved by stockholders or made under self-executing stockholder-approved plans in order to avoid heightened judicial scrutiny. Nevertheless, as the Supreme Court's decision in *Investors Bancorp* illustrates, if decisions regarding non-executive director compensation are considered together or substantially contemporaneously with grants to executive directors, a court may have reason to question the compensation committee's independence with respect to such grants. As this could undermine the committee's business judgment, it may be advisable for compensation committees to separately consider executive and non-executive director compensation at different points throughout each year to avoid any such implication. ■

[54] *See, e.g.*, *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 59 (Del. 2006); *Brehm v. Eisner*, 746 A.2d 244, 261–62 (Del. 2000) (holding that directors were protecting in relying on compensation consultants under Section 141(e)).

[55] *See, e.g.*, *Cirillo Family Trust v. Moezinia*, 2018 WL 3388398 (Del. Ch. July 11, 2018) (granting summary judgment in favor of defendant directors responsible for sending a "seriously flawed" notice of merger and appraisal rights to stockholders that was "totally bereft of information required under Delaware law" because the directors reasonably relied on outside counsel to prepare the notice in accordance with Delaware law); *In re Ebix, Inc. S'holder Litig.*, 2018 WL 3545046, at *13 (Del. Ch. July 17, 2018) (order) (dismissing claims challenging the adequacy of disclosures against directors who joined the board after the action underlying the disclosures occurred because they were entitled to rely on the corporation's records and the assurances of the other directors under Section 141(e)). Although reliance on experts may not provide a complete defense to any challenge implicating the entire fairness standard, it "is a pertinent *factor* in evaluating whether corporate directors have met a standard of fairness." *Valeant Pharms. Int'l v. Jerney*, 921 A.2d 732, 751 (Del. Ch. 2007) (quoting *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1142 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995)), *appeal dismissed*, 929 A.2d 784 (Del. 2007) (table).