

Discretionary Equity Awards to Directors Subject to “Entire Fairness” Standard of Review

January 2, 2018 – Governance & Compliance Insider
by Kimberley R. Anderson

Human nature being what it is, the law, in its wisdom, does not presume that directors will be competent judges of the fair treatment of their company where fairness must be at their own personal expense.^[1]

According to the Delaware Supreme Court in *In re Investors Bancorp, Inc. Stockholder Litigation*, when equity awards are granted to directors under a stockholder-approved equity incentive plan that gives directors discretion to determine the size of the awards, the awards are subject to the “entire fairness” standard of review. This decision may expand stockholder litigation in the area of director compensation.

When reading the recent opinion issued by the Delaware Supreme Court in *In re Investors Bancorp, Inc. Stockholder Litigation*, it is tempting to regard the dispute as a perfect example of “pigs get fat, hogs get slaughtered” and minimize the issues raised by the case. After all, on the heels of stockholder approval of an equity compensation plan, the 12-person Bancorp Board awarded themselves over \$51 million in equity grants from plan; the non-employee directors each received grants valued at approximately \$2 million (as compared to average awards of approximately \$176,000 for non-employee directors at peer companies). Your company’s board, you tell yourself confidently, would never act in such a manner. However, even the most prudent of Boards needs to consider the implications from the *In re Investors Bancorp* decision.

But first, let’s step back and look at a bit of background in the case:

- In June 2015, stockholders approved Bancorp’s Equity Incentive Plan (the “EIP”), which reserved 30,881,296 common shares for various types of equity grants for the Company’s 1,800 officers, employees, non-employee directors, and service providers, of which up to 30% were available to be granted to non-employee directors.
- Two weeks following stockholder approval of the EIP, the Board approved the grants noted above.
- Disclosure of the equity grants resulted in three stockholder complaints being filed in

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the Court of Chancery alleging breach of fiduciary duties by the directors for awarding themselves excessive compensation.

- The Court of Chancery dismissed the complaint because the EIP contained “meaningful, specific limits on awards to all director beneficiaries.” In other words, because stockholders approved the EIP, which the Court of Chancery noted contained meaningful limits, the ratification defense came into play, which allowed the Board’s actions to be reviewed under the business judgement standard.
- In December, the Delaware Supreme Court reversed the Court of Chancery’s decision and determined that the “entire fairness” standard applied.

The Delaware Supreme Court noted that because director compensation determinations are inherently self-interested, those decisions will be reviewed under the business judgment rule only where fully-informed stockholders approve (i) specific compensation decisions or (ii) self-executing plans (plans with fixed criteria). However, if a stockholder-approved equity incentive plan gives directors discretion within general parameters when compensating themselves, then the “entire fairness” standard is appropriate.

As the Supreme Court noted:

We think, however, when it comes to the discretion directors exercise following stockholder approval of an equity incentive plan, ratification cannot be used to foreclose the Court of Chancery from reviewing those further discretionary actions when a breach of fiduciary duty claim has been properly alleged. As the Court of Chancery emphasized in *Sample*, using an expression coined many years ago, director action is “twice-tested,” first for legal authorization, and second by equity. When stockholders approve the general parameters of an equity compensation plan and allow directors to exercise their “broad legal authority” under the plan, they do so “precisely because they know that that authority must be exercised consistently with equitable principles of fiduciary duty.” The stockholders have granted the directors the legal authority to make awards. But, the directors’ exercise of that authority must be done consistent with their fiduciary duties. Given that the actual awards are self-interested decisions not approved by the stockholders, if the directors acted inequitably when making the awards, their “inequitable action does not become permissible simply because it is legally possible” under the general authority granted by the stockholders.

So, what does this mean for Boards and Compensation Committees?

- If designing a new equity incentive plan, or amending an existing plan, consider whether self-executing awards to non-employee directors are appropriate or desired. If self-executing awards are not desired, determine if the plan contains significant and meaningful limitations on awards, as this might assist with the defense against a claim that the Board violated its fiduciary duties.
- If equity awards to directors are unusual in size compared to prior awards, consider

making the awards subject to stockholder ratification at the next stockholders' meeting.

- Have the Board and Compensation Committee pay close attention to compensation at peer companies and its own historical pay practices. Significant deviations from either may be more likely to trigger stockholder litigation under the new standards.

[1] Footnote 2 to *Investors Bancorp* opinion, citing *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660, 663 (1952)