December 2017

# New Delaware Supreme Court Decision Could Recalibrate How Directors Approach Their Pay

*A new court ruling could make it harder for companies to dismiss lawsuits alleging excessive director pay. We explain the case and provide guidance for avoiding potential litigation.*

In recent years, plaintiffs' lawyers have turned their aim to director compensation. Their lawsuits generally allege that directors provide themselves too much equity, thus breaching their fiduciary duties and wasting corporate assets. Now, a new court ruling could make it harder for companies to dismiss these lawsuits.

Historically, director equity plans that are ratified by shareholders are held to the more deferential business judgment rule. For equity plans that provide for fixed grants and no board discretion, stockholders know exactly what they are approving, and ratification generally inoculates directors. Equity plans that provide for discretion if there are "meaningful limits," may also be defended if there is stockholder ratification. Absent such meaningful limits, though, the reasonableness of the equity grants is subject to review under the more exacting "entire fairness" standard.

## Recent Court Decision

Earlier this month, the Delaware Supreme Court ruled in the case *Re Investors Bancorp, Inc. Stockholder Litigation* that when a stockholder-approved equity plan provides directors with discretion to grant themselves awards of up to 30% of all restricted stock and option shares authorized under the plan, and a stockholder properly alleges that the directors inequitably exercised that discretion, directors will be required to prove the entire fairness of the awards to the corporation.

In the past, the defense that stockholders ratified the equity awards might be enough to dismiss the suit. But given this new ruling, stockholder ratification of broadly-worded maximum share or value limits on director equity may not be sufficient anymore to defend directors from plaintiff's claims. While greater specificity in your director equity plans may provide more protection against a lawsuit, it comes at the price of flexibility.

Under this ruling, the more detailed or limiting the grants or amount of compensation approved by shareholders, the more valuable the stockholder ratification is to protecting directors. In the *Investors Bancorp* case, shareholders ratified the pay plan with a limit of 30% of shares reserved for directors. However, the board granted 30% of shares all in the first year of the plan. Furthermore, the director grants were above the company's peer group.

Empower Results®

If a board is perceived as having a high degree of discretion over how much equity to grant to directors, then it is unlikely that a limit on the amount of equity compensation that may be granted to directors would be sufficient to protect directors.

Even when shareholders approve a plan containing directors' discretionary authority to make grants within general parameters, the board must still bear the burden of demonstrating that specific grant decisions are reasonable. Under this particular court decision, general limits on director awards are not sufficient to insulate directors from derivative suits. Rather, directors must still bear the burden of proving that each grant was reasonable. As such, careful attention to peer practices is critical to demonstrating the reasonableness of each grant. To gain maximum protection, boards must be very specific in limiting their discretion on an annual basis, as an overall percentage of the pool limitation was not enough to avoid exposure in this court case.

## Key Takeaways

In this case, the court has said shareholder ratification of equity incentive plans works as a defensive argument for dismissing the suit under three circumstances: 1) When stockholders approve the specific director awards; 2) When the plan is self-executing, meaning the directors had no discretion when making the awards; or 3) When directors exercise discretion and determine the amounts and terms of the awards after stockholder approval.

The court held in this case that the plaintiffs successfully argued there was enough evidence that directors breached their fiduciary duty under the third circumstance listed above to go to trial.

We recommend companies take the following steps in response to this new court ruling:

- Review how your company currently assesses director compensation to determine whether a change in your processes to narrow the scope of director discretion is called for. This can include requiring narrowly tailored (or absolute) annual limits to director equity grants.

- Determine whether a fixed share and/or fixed value approach to regular annual director equity compensation grants is warranted.

- Consider benchmarking director compensation amounts and designs relative to relevant peers, industries and indexes to determine if any of your current practices are outliers.

# About Radford

Radford delivers talent and rewards expertise to technology and life sciences companies. We empower the world's most innovative organizations—at every stage of development—to hire, retain and engage the amazing people they need to create amazing things. Today, our surveys provide in-depth rewards insights in 80-plus countries to more than 3,000 client organizations, and our consultants work with hundreds of firms annually to design talent and rewards programs for boards of directors, executives, employees and sales professionals. Radford is part of the Talent, Rewards & Performance practice at Aon plc (NYSE: AON). For more information, please visit radford.aon.com.

# About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance. For further information on our capabilities and to learn how we empower results for clients, please visit aon.mediaroom.com.