The Delaware Supreme Court

Say on Director Pay

New limits on board discretion.

BY DOUG RAYMOND

Boards of directors have long set their own compensation, creating an inevitable conflict of interest, but change is on the horizon thanks to a recent Delaware Supreme Court ruling.

Based on past court decisions, if shareholders voted to give directors the authority to use their discretion to make compensation awards to themselves, boards had significant protection against litigation challenging those decisions. This is known as the ratification defense.

Last December, however, the Delaware Supreme Court significantly narrowed this ratification defense in *In re Investors Bancorp, Inc.* and shifted the focus away from stockholder ratification of "meaningful limits," i.e. general parameters that confine the directors' compensation awards.

In *Investors Bancorp,* a derivative suit was filed against the company's board for a breach of the directors' duty of loyalty, alleging that the directors awarded themselves excessive stock-based compensation. Looking to the existing Chancery Court cases, the directors relied on the stockholder ratification defense. They argued that the stockholders had both approved the equity plan and ratified the "meaningful limits" applicable to director compensation.

These limits, however, were not very restrictive – the directors could allocate up to 30% of all option or restricted stock available under the entire plan to themselves. According to the stockholders' complaint, the total value of the award was almost $52 million, and certain directors' individual awards were over 2,500% higher than average awards at peer companies.

> As the Court observed, although the stockholders "granted the directors the authority to make awards," the directors must still "exercise . . . that authority . . . consistent[ly] with their fiduciary duties."

Nonetheless, the Chancery Court agreed with the directors and dismissed the suit on ratification grounds because the awards were within the limits set out in the stockholder-approved plan.

On appeal, the Delaware Supreme Court reversed the Chancery Court decision.

The court reviewed stockholder ratification of director compensation in the earlier cases and held that stockholder ratification applies where the stockholders have specifically approved the board action. The court held that it is not sufficient for the stockholders merely to authorize the directors to use their discretion to determine their own compensation under an overarching compensation plan. The ratification defense is available only if stockholders approve the specific amount of director compensation or the formula for determining compensation, leaving no discretion to the board as to the amount.

The court made clear that if the board retains discretion in setting its own compensation, even within fair and reasonable parameters approved by the stockholders, that compensation decision will be subject to Delaware's "entire fairness" standard of review. Under this standard, directors must show that both the process used to set their compensation, as well as the actual amounts approved, were entirely fair to the corporation. As the court observed, although the stockholders authorized the directors to make awards, the directors must still exercise that authority consistently with their fiduciary duties.

Although the Investors Bancorp case dealt only with equity compensation, i.e., stock options and restricted shares, the principle of the case likely applies to cash payments as well. Indeed, an earlier Delaware Supreme Court case, as well as in several Chancery Court decisions, had previously reviewed cash compensation plans for directors under the entire fairness standard.

So long as a board can demonstrate that the stockholders approved the amount awarded, or more than what was awarded, a board typically should be able to rely on shareholder ratification to defend any challenge to the compensation decision.

Following this decision, boards should consider whether to submit specific director awards or the formula governing these payments to a stockholder vote. Doing so would restrict the board's ability to increase director compensation from the approved amount (as any increase would be subject to entire fairness review).

However, directors retain the flexibility to reduce the amounts paid from the level approved by the stockholders. And the board retains discretion to set the level of their compensation.

So long as a board can demonstrate that the stockholders approved the amount awarded, or more than what was awarded, a board typically should be able to rely on shareholder ratification to defend any challenge to the compensation decision. Awards over amounts approved by shareholders will be subject to entire fairness review.

Notably, the process undertaken by the board, and how well it documents that process, often determine how courts view the fairness of board action.

For example, how did the board choose and assure the independence of its compensation consultants? What guidelines were the consultants given in considering the board compensation structure? Was the board's review of the compensation careful and deliberate, or was it approved quickly after review at a single meeting? Perhaps most important, who were the peer companies chosen for comparative purposes, how were these comparable companies chosen, and what role did the board play in choosing them? What other peer groups were considered and how do the board's pay practices stack up against them? And the process undertaken by the board should be carefully documented.

After *Investors Bancorp,* directors may no longer rely on a broad grant of discretion tucked into an omnibus employee equity plan. ■

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