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Executive Compensation and Corporate Governance Client Alert: Director Equity Awards

A recent case out of the Delaware Supreme Court, *In re Investors Bancorp, Inc. Stockholder Litigation* raises concerns about the limits of the stockholder ratification defense when directors make equity awards to themselves under the general parameters of an equity incentive plan. Without the availability of the stockholder ratification defense, such awards are subject to the "entire fairness" standard rather than the deferential business judgment standard of review.

In *Bancorp*, the non-employee directors made grants to themselves, and two executive directors, following consultation with a compensation consultant. According to the complaint, the study produced by the compensation consultant was driven by a self-selection bias which did not accurately represent market compensation and the resulting awards were substantially higher than the average of peer companies (e.g., in one case, 2,571% higher).

Past litigation on this matter has accepted the stockholder ratification defense in three situations – (1) when stockholders directly approved the specific director awards; (2) when the plan was self-executing, meaning the directors were not able to exercise discretion when making the awards; or (3) when the directors exercised some level of discretion and determined the amounts and terms of the awards after stockholder approval of a general equity compensation plan. While the first two scenarios do not raise any significant issues, as the shareholders know the specific terms of the awards being approved, the third circumstance is more complicated.

In *Calma on Behalf of Citrix Systems, Inc. v. Templeton*, the Court of Chancery disallowed the defense with respect to director grants made under an equity compensation plan which contained only a generic limit covering director and non-director beneficiaries, with no separate limit on grants made to directors. Meanwhile, in *In re 3COM Corp.*, the court dismissed a complaint against the non-employee directors because the equity plan in that case contained "meaningful, specific limits on awards to all director beneficiaries." These cases led to an understanding that as long as an equity compensation plan contains a separate, meaningful, and specific limit on the number of equity awards which may be made to non-employee directors under a broad-based plan which was approved by the stockholders, then the stockholder ratification defense would be available and the business judgment rule would apply in the event there was a challenge to the subsequent awards made to the directors and approved by the directors following stockholder approval of the broad-based plan.

The Delaware Supreme Court's decision in *Bancorp* appears to overrule this understanding and stands for the proposition that, absent stockholder approval of the specific terms of the awards to the directors, or approval of a formulaic, self-executing plan, the directors' exercise of discretion within the general parameters of a stockholder-approved equity incentive plan will require the directors to demonstrate that their self-interested actions are entirely fair to the company; in other words, the actions will be reviewed under the entire fairness standard and not under the business judgment standard of review. This appears to be the case even where the equity compensation plan in question contains meaningful and specific limits on the number of awards that can be made to directors under the plan.

In addition, the Delaware Supreme Court also excused the plaintiffs from making a demand on the board for awards made to two executive directors who also received substantial equity awards. The two executive directors were not involved in making their respective grants, but the court stated that the non-employee directors were not "independent" in making the grants to the executive directors as the grants resulted from nearly contemporaneous meetings; the court considered it implausible 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. In other words, if the directors wanted to make excessive grants to themselves, they would likely make excessive grants to the executive directors as well in order to justify their own grants.

There are a few important takeaways from this case that companies should consider when setting up equity incentive plans and making grants to directors. First, companies should consider setting up a formulaic structure for making director grants each year and having such structure ratified by the stockholders, with no director discretion involved; this should still permit the stockholder ratification defense and provide business judgment review. Second, companies should have a distinct and separate process for setting the equity grant levels to executive directors; this should not be conducted contemporaneously or as part of the same process used in determining director compensation. Finally, as a matter of good governance practices, boards should impress upon compensation consultants the need to use accurate and representative peer groups rather than self-selecting peer companies in order to achieve a desired result.

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Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the members of our Executive Compensation and Corporate Governance Group.

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