Agenda

Opinion

Time to Seriously Reconsider Director Compensation

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Jim Barrall

Jim Barrall is a senior fellow in residence at the Lowell Milken Institute for Business Law and Policy at the **UCLA** School of Law. He is a retired partner of **Latham & Watkins**.

The Delaware Supreme Court issued its unsettling decision on excessive-director-pay lawsuit In re Investors Bancorp last December, now giving boards time to rethink director comp plans before their 2019 meetings — and now they have new reasons to do so.

In Investors Bancorp, the court overturned the Chancery Court's decision that shareholder approval of an equity plan that limited the number of shares that could be awarded to non-employee directors under a "meaningful limit" constituted "shareholder ratification" that enabled the defendants to have a lawsuit challenging their pay as excessive dismissed under the director-friendly "business judgment rule." Rather, the Supreme Court held that shareholder approval of a plan's general parameters does not constitute "ratification" and that if plaintiffs properly allege a breach of fiduciary duty, any discretion employed by directors in setting their own compensation must be defended under the rigorous "entire fairness" standard. This puts the burden on the directors to prove that their compensation was entirely fair, both in amount and in process.

According to the Supreme Court, a ratification defense is available if shareholders approve specific awards or plans that are self-executing, but not where directors have discretion to determine the awards. The decision upset the logic of earlier Chancery Court decisions in Seinfeld v. Slager and Calma v. Templeton, which had held that "meaningful limits" could support a ratification/business judgment defense. It also surprised many companies that amended their plans after Calma to impose "meaningful" limits on the amount of director compensation (generally, two to three times their current levels).

The implications of Investors Bancorp will play out over time. However, new developments give boards more reasons to consider adopting plans with pay limits that are subject to little discretion. Moreover, there is no reason to expect that things will get better in the courts.

First, although the facts of Investors Bancorp were bad (beginning with its large and unconventional limit on director awards), the Supreme Court's decision gave no comfort to conventional "meaningful limits" and made it clear that any discretion used by interested directors is subject to potential challenge under the entire fairness standard.

Second, if companies cannot exit these cases on motions to dismiss, they are highly likely to settle, considering the cost and burden of litigating them to trial under the entire fairness standard. Practically speaking, if a case can't be dismissed under the business judgment rule, the plaintiffs have won the battle, with only the company's settlement costs and burdens to be determined.

Third, the recent settlements in Solak v. Barrett and Fulton v. Dipp appear to have been heavily influenced by Investors Bancorp and indicate that companies face greater risks than having to pay the plaintiffs' attorneys' fees. Plaintiffs now are demanding much tighter control over plan terms, shareholder votes, governance processes and proxy disclosures than in the pre-2018 case settlements (for example, mandatory triennial say-on-director-pay votes were required in Fulton).

Fourth, it is far better for companies to control the terms of their director compensation, plan designs, shareholder vote frequencies, etc., than to have them imposed in litigation by plaintiff's lawyers working to justify their attorneys' fees. (For example, in Solak, Clovis Oncology was forced to subject its free-standing director compensation policy to shareholder vote, only to see it fail, which might have been avoided if the company had completely controlled the process.)

Finally, companies can design director compensation under omnibus plans that can be amended and approved periodically as necessary, in ways that would not make them worthwhile targets for any lawyer. For example, JPMorgan Chase recently obtained approval for its thoughtfully amended 2015 omnibus incentive plan, which prescribed director compensation amounts, subject to bands of limited discretion (which would not be worth litigating if exercised) and with broad safety valve discretion provisions (which likely would not be used except in extraordinary circumstances by board members who are "disinterested" and could therefore rely on the business judgment rule). This formula and others have much to recommend them. Directors should analyze them, and the recent cases, with their legal and other advisors.