



Guarding Against Challenges to Director Equity Compensation

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There has been an emerging litigation trend in Delaware, where most U.S. public companies are incorporated, alleging that directors breached their fiduciary duties and committed waste of corporate assets in granting themselves excessive awards under the company's equity compensation plan.¹ Because directors have a direct interest in their own pay, Delaware courts have held that board decisions on director compensation do not receive the protection of the business judgment rule without proper stockholder ratification.

When dealing with stockholder lawsuits, the often crucial issue faced by many public companies is whether they can avoid discovery. If a stockholder lawsuit can survive a motion to dismiss, the nuisance nature of discovery may significantly increase the case's settlement value, regardless of whether the plaintiff can eventually prevail. Absent the protection of the business judgment rule, it could be difficult to dismiss stockholder complaints at the pleadings stage, and the corporate defendants may face an unpleasant choice between continued litigation with all of its risks and distractions or a costly settlement.

Therefore, in light of the latest Delaware cases involving director compensation, it would be prudent for public companies to consider putting in place additional safeguards to fend off similar litigation. A recent decision from the Delaware Court of Chancery, *In re Investors Bancorp, Inc. Stockholder Litigation*,² when reviewed in comparison with the Delaware Court of Chancery's precedents, provided helpful guidance in this area.

Standard of Review

Under Delaware law, board decisions are generally protected by the business judgment rule, and the burden falls on the challenging plaintiff to prove that there exists bad faith, self-dealing or corporate waste. However, if the directors are interested in a transaction, which would occur if they will receive a benefit that does not accrue to stockholders generally, the standard of review will shift to entire fairness and the burden will be on the corporate defendants to establish that the transaction, including the process followed and the amount paid, when viewed objectively at the

¹ Rely on stockholder-approved standalone director equity plans was common until 1996 when the Securities Exchange Act Section 16 rules, which had required that director awards be subject to stockholder approval, were eliminated. With such rule change, issuers began adopting omnibus plans covering employees, officers and directors altogether.

² C.A. No. 12327-VCS (Del. Ch. Apr. 5, 2017).

time of approval, was fair to the corporation and its stockholders as a whole. Interested directors, however, may still be afforded the protection of the business judgment rule if a properly-informed disinterested majority of stockholders approves the transaction.

For various reasons, including exchange-listing standards,³ public company equity compensation plans are typically submitted for stockholder approval. Recent Delaware court decisions, however, suggest that without careful advance planning, such approval may not be sufficient to avail the public company and its directors the protection of the business judgment rule and insulate them from legal challenges.

Recent Legal Challenges

Historically, directors' decisions in administering a stockholder-approved equity compensation plan, including granting themselves equity awards, were entitled to the protection of the business judgment rule in Delaware as long as such decisions are consistent with that plan.⁴ In *In re 3Com Corp. S'holders Litig.*,⁵ the Delaware Court of Chancery applied the business judgment rule and dismissed a claim based on stock options that directors of 3Com Corporation ("3Com") granted to themselves where the plaintiffs alleged that the options had a value that was "quite large (at least \$650,000 per director)."⁶ The stockholder-approved plan of 3Com capped the number of shares that could be granted for each type of board service each year at maximums of 60,000 shares for board members and of 80,000 shares for the chairman (plus up to 24,000 for service on a board committee). Within this framework, the annual grants unsuccessfully challenged in *3Com Corp.* were between 22,500 and 70,000 shares.

The Delaware Court of Chancery, however, altered this landscape in a series of recent decisions: *Seinfeld v. Slager*, *Calma v. Templeton*, and *Espinoza v. Zuckerberg*.⁷ In all of these cases, the Delaware Court of Chancery held that stockholder approval of an omnibus equity compensation plan would not constitute ratification of non-employee director compensation in the absence of specific and meaningful limits in the plan on the amount of compensation that could be awarded to non-employee directors. With the challenged director compensation being held to be judged under the entire fairness standard, unsurprisingly, each case survived a motion to dismiss and was settled with a hefty award to plaintiff's counsel (about half a million dollars).

Seinfeld v. Slager

In *Seinfeld*, the plaintiff accused the directors of Republic Services, Inc. ("Republic"), of breaching their fiduciary duties and wasted corporate assets by awarding themselves excessive compensation under a stockholder-approved equity compensation plan that far exceeded what was paid by Republic's peers.⁸ Holding that stockholder-approved carte blanche to the directors

³ See NYSE Listed Company Manual § 303A.08 and Nasdaq Listing Rule 5635(c).

⁴ In *Weiss v. Swanson*, 948 A.2d 433 (Del. Ch. 2008), the Delaware Court of Chancery stated that directors' grant of stock options to themselves pursuant to a stockholder-approved plan are entitled to business judgment deference as long as the terms of the plan at issue are adhered to.

⁵ 1999 WL 1009210 (Del. Ch. Oct. 25, 1999).

⁶ A *Black-Scholes* value based on a value of about \$40 per share of 3Com stock at the time the contested 3Com awards were granted.

⁷ 2012 WL 2501105 (Del. Ch. June 29, 2012); 114 A.3d 563 (Del. Ch. 2015); and 124 A. 3d 47 (Del. Ch. 2015).

⁸ During the two years in dispute (2009 and 2010), each Republic non-employee director's annual compensation, including RSUs granted under the plan, was between \$320,000 and \$345,000, and between \$843,000 and \$891,000, respectively.

is insufficient to afford them the business judgment rule protection, the *Seinfeld* court denied the defendant directors' motion to dismiss. The court distinguished *3Com Corp.* by finding that in *3Com Corp.* business judgment deference applied because the stockholder-approved plan had sufficiently defined terms and meaningful limits on director discretion. The court explained that the more definite a plan is, the more likely that a board's compensation decision under the stockholder-approved plan will qualify for the protection of the business judgment rule.

In reaching its decision, the *Seinfeld* court focused on the sole discretion of Republic's board to set awards under the plan subject only to an individual limit of 1,250,000 shares and a total limit of 10,500,000 shares per year. As Republic's board could theoretically award each non-employee director up to \$21,691,250 worth of stock, which would be \$260,295,000 in total,⁹ the court did not consider the limits to be meaningful, and therefore despite stockholder approval of the plan, did not apply the business judgment rule. The court further noted that a generic limit on a range of beneficiaries with differing roles was not sufficiently specific to director compensation to support a stockholder-ratification defense.

The *Seinfeld* lawsuit was settled with Republic, in addition to covering the plaintiff's attorneys' fees and expenses up to \$495,000, agreeing not to grant to a non-employee director awards under the plan that would result in more than 15,000 restricted stock units ("RSUs") vesting in a calendar year in the ordinary course (excluding accelerated vesting upon death, disability, termination of service).

Calma v. Templeton

Drawing on its prior opinion in *Seinfeld*, the Delaware Court of Chancery in *Calma* denied a motion of the defendant directors of Citrix Systems, Inc. ("Citrix") to dismiss a claim that they breached their fiduciary duties and wasted corporate assets in awarding themselves excessive compensation under the company's stockholder-approved equity compensation plan in comparison to the compensation received by directors at Citrix's peer companies. In reaching this decision, the court applied the entire fairness standard, rather than the business judgment rule.

Citrix officers, employees, consultants, and advisors were eligible to receive awards under the plan. The plan provided that no participant could receive grants covering more than 1 million shares or RSUs per calendar year, but otherwise did not contain any individual limits on awards. In particular, the plan did not impose any specific limits on grants to non-employee directors. Based on Citrix's stock price on the day that the action was filed, a grant of one million shares would have amounted to granting the recipient equity valued at over \$55 million.¹⁰

The *Calma* lawsuit was settled with Citrix agreeing to pay up to \$425,000 to plaintiff's counsel and implement and maintain certain corporate governance reforms for a period of no less than five years, including amending its equity compensation plan to cap the grant-date value of the annual equity compensation to each non-employee director thereunder at \$795,000.

⁹ Republic's stock had a value of approximately \$24.79 per share at the time that the contested equity awards were granted. Since there were 12 Republic directors, the total limit instead of individual limit applied. During 2009 and 2010, Republic's board granted non-employee directors RSUs worth about \$750,000 and \$215,000 per director, respectively.

¹⁰ From 2011 to 2013, the compensation committee of Citrix board awarded over one million dollars in cash compensation and RSUs to each of the company's non-employee directors.

Espinoza v. Zuckerberg

In *Espinoza*, the plaintiff alleged that the directors of Facebook, Inc. (“Facebook”) awarded themselves unfair, excessive compensation and are therefore liable for breach of fiduciary duties and waste of corporate assets. Prior to its initial public offering, Facebook’s stockholders adopted an equity compensation plan with a total cap of 25 million shares for the entire program and an individual annual limit of 2.5 million shares. At the time of the complaint, 2.5 million Facebook shares were worth about \$145 million, which the plaintiff alleged was not a true limit.

Facebook’s compensation committee subsequently made recommendations to its board to increase the annual cash retainer for the audit committee members from \$50,000 to \$70,000 and to provide each non-employee director annual RSUs worth about \$300,000, with Mr. Mark Zuckerberg, who controlled over 61% of the company’s voting power and was its chairman, being present. A few weeks later, the Facebook board approved the recommendations. Facebook’s motion to dismiss, supported by an affidavit from Mr. Zuckerberg expressing his approval of the director compensation increase, was denied on the basis that Mr. Zuckerberg never executed a written consent required under Delaware law, which would have triggered an obligation to notify non-consenting stockholders of the action taken, and the *Espinoza* court determined that the entire fairness standard should apply in reviewing the Facebook board’s decisions relating to director compensation.

Even though the issue was not specifically discussed in the decision, the *Espinoza* court seemed to suggest that Facebook’s stockholder-adopted equity compensation plan by itself was not enough to ratify the increased director compensation, which was within the outer limits of the plan. Otherwise, a further formal written consent by the controlling stockholder specific to the increase would not be necessary.

After failing to dismiss the complaint, Facebook agreed to a settlement that required it to pay attorneys’ fees to plaintiff’s counsel up to \$525,000 and to implement and maintain certain corporate governance reforms. Pursuant to such settlement, at 2016 annual meeting, Facebook asked its stockholders to ratify RSUs granted to its non-employee directors in 2013, 2014 and 2015 as well as to approve its annual compensation program for non-employee directors.¹¹

Investors Bancorp Decision

There was, however, little guidance from *Seinfeld*, *Calma*, and *Espinoza* on the required level of detail for director compensation limitations in a stockholder-approved equity compensation plan in order to qualify directors’ decisions in granting themselves awards thereunder for Delaware courts’ business judgment deference.

Consistent with its tradition of providing companies and stockholders more certainty with respect to the outcome of intra-corporate disputes, the Delaware Court of Chancery in *Investors Bancorp* struck a workable balance between narrowing directors’ discretion under a stockholder-approved plan over equity awards to themselves, and ensuring that the board has flexibility to respond to future events and changed circumstances when setting director compensation.

¹¹ Facebook did not seek stockholder approval of director compensation at 2017 annual meeting.

In *Investors Bancorp*, after receiving stockholder approval of an equity compensation plan, under which 30,881,296 shares are reserved for equity awards to officers, employees, non-employee directors, and service providers of Investors Bancorp, Inc. (“Bancorp”), the directors of Bancorp granted themselves restricted stock and stock options. The plan imposed limits on the number of shares that can be issued as stock options (a maximum of 17,646,455) or as restricted stock awards or RSUs (a maximum of 13,234,841). In addition, the plan had the following overall ceiling on awards to non-employee directors: The maximum number of shares that may be issued or delivered to all non-employee directors, in the aggregate, pursuant to the exercise of stock options or grants of restricted stock or RSUs, is 30% of the shares authorized under the plan, all of which may be granted during any calendar year. Based on its compensation committee’s recommendation, Bancorp’s board approved the challenged director compensation, which was within the plan-imposed ceiling (about 25% of the plan’s capacity). The grant date fair value of the awards for each of the 10 non-employee directors was about \$2 million (\$1,254,000 in restricted stock and \$780,000 in stock options), and based on that the plaintiffs sued for breach of fiduciary duties and waste of corporate assets.

Distinguishing between stockholder approval of, on the one hand, an equity compensation plan that features broad parameters and generic limits applicable to all plan beneficiaries (such as the plan in *Calma*) and, on the other hand, an equity compensation plan that sets specific limits on the compensation of a particular class of beneficiaries (such as the plan in *3Com Corp.*), the *Investors Bancorp* court held that approval of company-wide equity compensation plans with limits bearing specifically on the magnitude of compensation to non-employee directors would be deemed as ratification of awards that are consistent with those limits. The court further found that Bancorp’s equity compensation plan contained meaningful, specific limits on awards to director beneficiaries, and such restrictions differed from the limitations on awards to other plan beneficiaries (such as all employees as a group). As a result, even though acknowledging that the awards in question were quite large and above the level of director compensation at peer companies, the court was reluctant to second-guess an informed stockholder vote and dismissed the case after invoking the business judgment rule. The court reached its decision on the basis that, through a proxy statement filed prior to the stockholder vote to approve the plan, Bancorp’s stockholders were apprised of the parameters of the plan and knew that, once approved, Bancorp’s board could immediately start granting awards within those parameters. Observing that Bancorp’s board engaged expert advisors and undertook a lengthy process after stockholder approval of the plan in determining individual directors’ specific awards, including four formal compensation committee meetings, the court also rejected the argument that Bancorp’s board had already decided such awards prior to the stockholder approval.

Conclusion and Takeaways

Investors Bancorp did not seem to overrule the holdings in *Seinfeld*, *Calma*, and *Espinoza* that a mere approval by stockholders of an equity compensation plan with non-discriminating overall grant limits and without sub-limits varied by position with the company (such as a limit for non-employee directors and a different limit for officers) may not be able to insulate future actions by the directors within those broad parameters from challenges under the entire fairness standard.¹² Instead, *Investors Bancorp* upheld the effect of a fully informed stockholder approval of meaningful ceilings on potential director compensation on availing directors the protection of the business judgment rule. The authors believe that *Investors Bancorp* is a step forward to avoid

¹² *Calma*, 114 A.3d at 570.

the uncertainties and costs of the courts second-guessing disinterested stockholders' informed decisions. In practice, if stockholders disagree with directors' administration of a stockholder-approved plan within the plan's limits, including granting too much compensation to themselves, stockholders can always express their discontent in director elections.

To reconcile the Delaware Court of Chancery's precedents, one cannot help but notice that the amounts of the allegedly excessive director compensation in *Seinfeld*, *Calma*, and *Espinoza* do not seem particularly high compared to the director compensation in *3Com Corp.* and *Investors Bancorp*, where the stockholder challenges were successfully fended off at the motion-to-dismiss stage. Therefore, irrespective of the value of the underlying awards, to mitigate potential litigation risk, it seems advisable for public companies of all sizes to request stockholders to specifically approve parameters in granting directors equity awards. How to implement the request, however, requires careful consideration.

One approach is to put forward an annual non-employee director compensation program with specific annual equity awards to be granted to non-employee directors for stockholder vote, as Facebook did in 2016. The benefit of this approach is that it offers directors the maximum protection over potential challenges to their compensation, in which they are inherently self-interested. Once the compensation program is approved by stockholders, all director compensation, including the cash component, is protected by the business judgment rule. This approach, however, sacrifices flexibility in that the company will have to seek stockholder approval every time before increasing director compensation or otherwise deviating from the previously-announced director compensation practice, and thus could be burdensome for companies that are competing for talented directors. It is worth noting that Facebook took this approach pursuant to the *Espinoza* settlement and before *Investors Bancorp*.

Alternatively, public companies may choose to include director-specific limits in their equity compensation plans when submitting the plans to stockholders for reapproving.¹³ Such limits, however, must be meaningful to afford directors the protection of the business judgment rule. According to *Investors Bancorp*, to be meaningful, such limits need not to be expressed on an annual basis or specific to individual directors. Having caps on shares that could be granted under the plan to each group of recipients, with non-employee directors being a separate group, seems to be sufficient. With that being said, as suggested by *3Com Corp.*, when appropriate, public companies should consider setting annual individual limits on director compensation based on each type of board service (for example, a higher limit for the chair of the board or board members serving on multiple committees). Similarly, if equity awards set aside for directors are conceivably less than those to be granted to employees (including officers), it could make sense to use a more restrictive director-specific cap in the plan than the cap on employees' awards. When seeking stockholder approval, the more definite and differentiating those plan limits are, the more likely that Delaware courts will deem the awards granted within their bounds to be effectively ratified.

Public companies, especially those foreseeing potential volatility in their stock prices, should also consider describing limits on their director compensation in grant-date dollar amounts. In this form, if the company's stock price drops considerably, it does not have to wait until stockholder

¹³ Many public companies submit their equity plans to stockholders for reapproving of the list of performance goals thereunder every five years, or when the plans are being materially modified, in order for compensation paid to CEOs and certain other officers to be deductible by the company to the extent such compensation exceeds \$1 million per person per year under limits prescribed by Internal Revenue Code Section 162(m).

approval to make up such downturn by granting additional awards to directors in order to retain them.

In addition, to avoid the pitfall highlighted in *Espinoza*, the stockholder ratification should be accomplished formally either through a vote at a stockholders' meeting or by stockholders' formal written consent.

Furthermore, it is important to disclose fully and fairly all material information related to the proposed director compensation prior to seeking stockholder approval. Not only should the director-specific limits be highlighted to stockholders in sufficient detail, public companies may want to clearly identify the rational business purpose of the contemplated awards to directors, as such disclosure could make it harder to rebut the presumption under the business judgment rule that directors were acting in the best interest of the company.

Finally, *Investors Bancorp* illustrated the benefits of engaging expert advisors, undertaking a formal process of compensation committee and board meetings, and keeping records of such decision-making process in defending board decisions setting director compensation. It is important for public company boards to develop director compensation guidelines¹⁴ and to adhere to such guidelines and stockholder-approved plan limits in practice. Since the law is constantly evolving as a result of reinterpretations by the courts, and through the enactment of new legislation, public companies should be ready to defend the reasonableness of director compensation under the entire fairness standard, should constantly prepare and retain documents and data in support of boards' director compensation decisions (such as compensation consultant presentations and peer-group benchmarking data), and should vigilantly time the grants to avoid issuing equity awards in anticipation of the release of critical news.

In summary, because generic limits in stockholder-approved plans are not sufficient to overcome plaintiffs' assertions that directors' self-interest calls for heightened standard of review by Delaware courts, additional care will be needed in deciding whether and how to seek and obtain stockholder approval of director compensation at Delaware public companies, which if set by directors inherently involves conflicts of interest. The ultimate decision requires a judgment by the board about the trade-off between the greater legal certainty to be obtained through formal stockholder approval of specific compensation or limits against the loss of flexibility such approval may entail, the sensitivities involved in explaining equity plan amendments to stockholders when seeking stockholder approval,¹⁵ and the challenges of dealing with proxy advisors on such issues. To make an informed decision, the board should also assess the fairness of the company's director compensation against its peers and the likelihood of future scrutiny by stockholders, proxy advisors and the plaintiffs' bar of its compensation programs.

¹⁴ NYSE Listed Company Manual §303A.09 provides that listed companies must adopt corporate governance guidelines that must address, among other things, director compensation, and that director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate).

¹⁵ For tax-deductibility reasons discussed in *supra* note 13, if such changes are deemed material.