Delaware Court Of Chancery Reaffirms Entire Fairness Standard In Director Compensation

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On May 31, 2019, in Stein v. Blankfein, et. al., the Delaware Court of Chancery reaffirmed the Delaware Supreme Court’s holding in In re: Investors Bancorp, Inc. Stockholder Litigation (more information here) that the “entire fairness” standard applies with regard to director approval of director compensation. The Stein case builds on the precedent set in Investors Bancorp and provides additional insights.

In Investors Bancorp, the court concluded that, in most situations, directors’ actions to set their own compensation should be reviewed under an “entire fairness” standard because of the inherent conflict of interest involved. The burden is on the directors to demonstrate that the process and compensation amounts were fair. Investors Bancorp also held that stockholder approval of director compensation can serve to preclude a claim based on the entire fairness standard, but only if the stockholders approved a specific compensation award or a self-executing compensation formula.

In Stein, a stockholder-plaintiff alleged that the aggregate combination of cash and equity compensation paid to the company’s non-employee directors was “grossly excessive, so as to amount to a breach of the Directors’ fiduciary duty of loyalty.” In particular, the case centered on equity awards made to non-employee directors under the company’s stock incentive plans (“SIPs”) approved by stockholders. The director-defendants moved to dismiss the case on two primary grounds:

1. The directors’ equity compensation was awarded pursuant to the SIPs, which included language that constituted a waiver of the entire fairness standard; and

2. The stockholder-plaintiff failed to adequately allege the director compensation was not entirely fair.

Waiver of Entire Fairness Standard

The director-defendants argued that the “entire fairness” standard did not apply because the SIPs included language that absolved the directors of liability absent bad faith. Specifically, the SIPs included language that provided that “no member of the Board . . . shall have any liability to any person . . . for any action taken or omitted to be taken or any determination made in good faith with respect to the [SIPs] or any Award.”

The court rejected this argument because stockholder approval, in this context, did not represent a sufficiently knowing waiver of the entire fairness standard. The court held that the purported waiver language was insufficient since the bulk of the directors’ actions under the SIPs would not involve their own compensation and therefore the stockholders’ approval of the plans (and the general waiver language) was not specific enough to demonstrate a knowing waiver of rights with respect to directors’ self-dealing transactions.
Interestingly, although the court was dubious that stockholders could ever waive the right to redress for future and unknown unfair self-dealing transactions, the court noted that a valid waiver, to the extent such a waiver would even be possible under Delaware law, would, at minimum: (1) have to inform stockholders that the approved plan contemplated self-interested transactions subject to the entire fairness standard; and (2) provide that a vote in favor of the plan would amount to a waiver of a right to redress for such self-interested transactions even if the compensation was unfair.

**Motion to Dismiss**

The director-defendants also argued that the stockholder failed to adequately allege the director compensation was not entirely fair. The court rejected this argument. The stockholder-plaintiff had alleged that the director-defendants made nearly twice as much as counterparts at the company’s self-identified peer companies. The director-defendants noted that the board set compensation with the advice of an outside compensation consultant and that higher director compensation had not adversely hurt the company’s performance. The court, however, held that the stockholder-plaintiff had met the low pleading burden by pointing to “some facts” indicating a lack of entire fairness, which will now require a fact-based review of both amount and process.

**Takeaways and Next Steps**

Based on the current state of the law as set forth in Investors Bancorp and re-affirmed in Stein, we recommend companies and their boards of directors consider the following when setting director compensation:

- **Stockholder Approval of Specific Director Compensation or Self-Executing Plans.** To the extent possible and practical, companies should consider adopting director compensation policies that either (1) require stockholder approval for specific awards or (2) are stockholder-approved self-executing formula plans (i.e., when directors have no discretion in making awards). We realize, however, that getting specific stockholder approval for every director compensation decision or having a stockholder-approved self-executing director compensation plan will not be practical for many companies.

- **Adopt Meaningful Limits on Director Compensation.** If specific approval or approval of a self-executing plan is impractical, companies should consider adopting “meaningful” stockholder-approved limits on director compensation (whether on total compensation or equity awards). These limits should take into consideration market factors such as the director compensation levels of companies in a selected peer group.

- **Corporate Governance.** Boards should continue to pay close attention to their governance practices in setting their compensation, including: (1) establishing a process for annual or other periodic reviews of compensation; (2) benchmarking against peer group compensation; (3) utilizing compensation consultants; and (4) detailed disclosures of director compensation to stockholders.

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