Addressing Increased Scrutiny on Director Compensation: A Call to Action

– by Tom Ramagnano and Charles Grace

Executive compensation has long been subject to intense scrutiny from regulators, proxy advisors and investors alike. Until recently, outside director compensation has not been subject to similar scrutiny primarily due to the narrow range of pay practices for directors, in both pay value and design/delivery. However, a new heightened level of scrutiny is now being applied to outside director pay. This has prompted many companies and their boards of directors to consider what, if any, actions they might take to help mitigate the risk of lawsuits, proxy advisor criticism, and the associated bad press related to director compensation.

Background

Two developments are driving the increased scrutiny over director compensation. First, in recent years, Delaware court rulings have held that a company must have *meaningful limits* on non-employee director pay in order to receive the protection of a favorable standard of review in the event of shareholder litigation. Furthermore, the Delaware Supreme Court's most recent *Investors Bancorp* decision raises the question of whether companies should consider eliminating directors' discretion in setting their own compensation altogether. These rulings may lead to an increase in shareholder litigation challenging director compensation going forward.

Second, one of the larger proxy advisory firms, Institutional Shareholder Services (ISS), recently adopted a policy of recommending that shareholders vote against members of the board committee that are responsible for approving or setting non-employee director pay if there is a pattern of excessive director compensation without disclosing compelling rationale or other mitigating factors.

Prescriptive Responses

In response to the recent litigation and court decisions over director pay, many public companies have determined to include specific annual compensation limits on director compensation in their shareholder-approved equity plans. Some companies have implemented annual limits on total compensation (which is the most current trend), while others have implemented limits on individual pay components (i.e., separate limits on annual cash compensation and equity awards). A small number of others are contemplating whether to establish a fixed amount or formula for director compensation, thereby removing any use of discretion in setting pay levels.

Not surprisingly, some companies and their boards are resistant to impose such prescriptive restrictions, as they significantly limit boards' flexibility in setting director compensation, especially under special circumstances. Moreover, the implications of the recent line of Delaware court decisions do not provide bright line specific guidance as to how far a company must go to receive a favorable standard of review in the event of litigation. Lastly, imposing prescriptive limits by plan design and receiving shareholder approval on such plans comes at a cost to the company in terms of committing significant time and resources to the effort. Those companies may be more inclined to at least consider adding prescriptive limits if and when they have other reasons to take their plans back to the shareholders for approval (i.e., when they need a new pool of shares).

Alternative Governance Actions

Whether a company has already imposed or is planning to impose prescriptive restrictions on director pay or a company remains resistant to taking any such actions, there are several preemptive measures a company

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may consider to help minimize the risk of criticism from proxy advisors and investors, as well as the risk of lawsuits challenging director compensation, including:

- Adopt a formal outside director pay philosophy and focus on director pay governance processes, with annual peer group reviews, competitive benchmarking assessments and pay positioning evaluations;
- Apply a director pay limit (e.g., as evidenced in the relevant meeting minutes), even in advance of or in lieu of a shareholder-approved plan amendment imposing the same; and
- Provide clear proxy disclosure of a company's director pay philosophy, methodologies for setting director compensation and rationale for any pay decisions that may be unusual or a result of special circumstances.

Concluding Thoughts

While none of the prescriptive limits or governance actions referenced above guarantee that companies will avoid criticism or litigation over director compensation, plaintiffs' counsel are more likely to look for "low hanging fruit" among companies whose plans include no limits on director pay and/or have limited disclosure on the "how and why" for setting director pay.

Furthermore, understanding how recent court decisions and ISS's new policy against excessive director compensation might apply to a company's specific circumstances, and what actions the company and its board members should consider taking to minimize the risk of lawsuits or criticism, requires boards to engage in a careful balancing act of several competing factors. However, one thing appears certain – boards that continue to ignore the increasing focus on director compensation levels do so at their peril.

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