



## On Governance: More Bad News for Boards from the Director Compensation Litigation Front

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*On Governance is a series of guest blog posts from corporate governance thought leaders. The series, which is curated by the Governance & Sustainability Center research team, is meant to serve to spark discussion on some of the most important corporate governance issues .*

On May 31, Delaware Chancery Court Vice Chancellor Sam Glasscock filed his much-anticipated [decision](#) in *Shiva Stein (derivatively on behalf of Goldman Sachs Group) v Blankfein (former chair and CEO of Goldman Sachs Group), et al* on the defendants' motion to dismiss the plaintiff-shareholder's claims brought against Goldman Sachs and its directors, including its former Chair and CEO Lloyd Blankfein, attacking the directors' compensation and the adequacy of the company's proxy disclosures regarding its 2013 and 2015 stock incentive plans. The court declined to dismiss the truly important claim at the heart of the case: that the company's directors had breached their fiduciary duty to the company by overpaying themselves from 2015 through 2017.

However, the court dismissed the plaintiff's disclosure claims on which her lawyers contended that their lawsuit had a value to the company of \$1.4 billion which justified a proposed settlement for \$575,000 in legal fees. Accordingly, the case (filed in May 2017) now moves forward to a potential trial on the merits, in which the directors would have the burden of proving that their compensation was "entirely fair" to the company, that is that *both* the amount of and the process by which it was determined were fair.

While it could take years for the case to be resolved, nothing about the court's decision is helpful to directors who exercise discretion in setting their compensation.

The court's rejection of the defendants' motion to dismiss the excessive compensation

claim serves as one more reminder that thoughtful companies should review and consider restructuring their director compensation plans, especially if they are planning to submit their director compensation plans to shareholders for approval, as I recommended last June in my post [On Governance: Why and How Companies Should Now Review Their Director Compensation Plans](#).

Here is my assessment of the *Stein v. Blankfein, et al* motion to dismiss decision's important holdings and their implications for directors and companies:

1. **Bancorp meant what it said.** In December 2017, the Delaware Supreme Court decided [In Re Investors Bancorp Inc. Stockholder Litigation](#) and held that in defending their compensation directors cannot rely on the business judgment rule, which puts the burden on the plaintiffs to prove that the compensation was wasteful, and have the burden of proving the "entire fairness" of the compensation if they exercise discretion after shareholders approve the compensation plan and if plaintiffs properly allege a breach of fiduciary duty. Here the court stated and applied this holding without equivocation. Moreover, while the company's plans did not include any special limit on the amount of compensation payable to directors, nothing in the decision gives any comfort to the notion that shareholder approval of a separate "meaningful limit" on the directors' discretion can constitute shareholder ratification of the compensation which would support a business judgment defense and require the plaintiffs to prove that the compensation was wasteful. While shareholder approval of special and reasonable limits on the amount of director compensation (as implemented by many companies since the Delaware Chancery Court decision in *Calma v. Templeton* (2015)), may cause potential plaintiffs to pick other targets, they are unlikely to support a motion to dismiss a lawsuit once filed.
2. **Shareholder approval of a good faith standard did not override the entire fairness standard.** In a matter of first impression, the court rejected the defendants' contention that a provision in the company's plans that no director "shall have any liability to any person" for any action taken under the plan if the directors acted in 'good faith' overrode the entire fairness standard of review. While the court expressed skepticism that such a plan provision could be effective as a matter of law with respect to future and unknown self-dealing transactions, the court did not decide this issue but held that on these facts the plan provision and disclosure about it did not support a defense that the plaintiff had waived her individual and derivative rights to challenge the directors' compensation under the entire fairness standard.
3. **A low pleading burden is enough to trigger entire fairness scrutiny.** Following *Bancorp*, the court held that in order for the onerous entire fairness standard to apply not only must the directors have exercised discretion in setting their compensation but the plaintiffs must allege some facts that "tend to show that the transaction was not fair." The court labeled this a "low pleading burden" and held that plaintiff had met it by alleging that the directors' compensation was nearly twice as much as that of the company's self-selected peer group, the peer group's directors attended more board meetings and the peer companies had as good or better performance. In one bit of a silver lining, the

decision suggests that a simple allegation of above-average compensation might not be sufficient because, by definition, half of all companies would be over-compensating their directors. But on the flip side, it appears that even below-average compensation can constitute excessive compensation which can trigger the entire fairness standard if plaintiffs allege poor quantity or quality of director performance. For example, consider when director performance is reviewed in the rearview mirror after corporate risk failures.

4. **A fair compensation-setting process is not sufficient.** The entire fairness standard puts the burden on directors to prove both a fair price and a fair process. Here the plaintiffs did not allege that the company's compensation process was unfair, only that it paid an unfair price, and the defendants, in fact, pointed to elements of a fair process, like the use of an independent compensation consultant. However, under the court's analysis, a plaintiff is not required to allege that both the process and price were unfair. Successfully pleading either will suffice to defeat a defendant's motion to dismiss and permit a lawsuit to continue. This means that even companies whose compensation is fair in amount must pay attention to the fairness of their processes and that they are adequately disclosed.

While these holdings are not good news for companies seeking to dismiss director compensation lawsuits, they are not determinative on the merits. Here the court noted that the plaintiff's complaint was not "particularly strong" in its allegations of excessive director compensation. Moreover, in my view, there is nothing in the parties' motions or briefs in the case that suggests that in further litigation the company would not be able to prove that its director compensation was both fair in amount and process. But unless the case is settled on a basis that is substantially different from that of the proposed settlement that was rejected by the court in October 2018 or the plaintiff drops the case, proving this case likely will require the company and its directors to expend substantial time, effort and treasure, all of which could better be expended on other matters in the interest of the company and its shareholders.

My general view of this issue has not changed. Companies that are not already ensnared in director compensation lawsuits should carefully consider the court's wise admonition that "*Bancorp* has made clear the path by which directors can obtain ratification, which will eliminate the potential for liability for such directors who obtain ratification going forward."

You can see my post of last June (see link above) to learn more about why this is a good idea and how to do it.

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