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Ineffective Stockholder Approval for Director Equity Awards

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On December 13, 2017, the Delaware Supreme Court issued an opinion, *In re Investors Bancorp, Inc. Stockholder Litigation*, Case No. 169, holding that, except under limited circumstances, the court will not apply the deferential "business judgment rule" in reviewing challenges to director compensation awards granted pursuant to stockholder-approved equity plans. Instead, such awards are subject to an "entire fairness" standard of review. The ruling increases the likelihood that a plaintiff will defeat a motion to dismiss and potentially embroil the company in costly litigation and discovery.

Public companies should work with their compensation consultants to conduct a peer review of their director compensation programs in order to determine whether their director compensation, including equity grants, are reasonable. Companies should carefully document this process and consider the extent to which it may be beneficial to describe the process in their annual proxy disclosure. In light of the Delaware Supreme Court's opinion, companies also may wish to consider whether to provide for grants of director compensation awards pursuant to a stockholder-approved formula plan, or via grants of awards specifically approved by stockholders.

Background

Under Delaware law, a claim involving director conduct is generally subject to review under the "business judgment rule," under which the court will presume the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the decision at issue was in the corporation's best interest. This deferential standard does not apply if a majority of directors are interested in the decision or would derive a personal financial benefit from the decision. Consequently, claims relating to director compensation are typically reviewed under a more onerous level of scrutiny—the "entire fairness" test—which requires that directors bear the burden of proving that their compensation decision was entirely fair to the corporation.

However, if the board can show that the challenged decision was ratified by a vote of fully informed stockholders, then the entire fairness review will not apply, and director action will be

reviewed under the more deferential business judgment rule. In recent years, a number of cases have examined the extent to which shareholder approval of an equity-compensation plan is sufficient to cause grants to directors under such plans to be analyzed under the business judgment rule. See "Fairness of Director Awards Granted Under Market-Standard Equity Plans Comes Under Increased Scrutiny." Previously, the Delaware Court of Chancery has held that stockholder approval of a discretionary equity plan could constitute "ratification" if the equity plan contained a "meaningful limit" on director compensation. For additional background on director compensation litigation, see Skadden's 2017 *Compensation Committee Handbook*.

Decision

In *In re Investors Bancorp, Inc. Stockholder Litigation*, 2017 WL 1277672 (Del. Ch. April 5, 2017), the board of directors of Investors Bancorp submitted an equity plan for stockholder approval pursuant to which the maximum number of shares that could be issued to all non-employee directors totaled 30 percent of all option or restricted stock shares available for awards. The plan did not impose any other limits on grants to directors. After the plan was approved by the company's stockholders, the directors awarded themselves equity awards, the aggregate grant date fair value of which for all 12 board members was approximately $51.5 million. The plaintiff alleged that the directors' compensation exceeded the compensation paid to directors of peer companies. Although the Court of Chancery noted that the director awards in this case appeared to be quite large, the Court of Chancery dismissed the case because the plan contained "meaningful, specific limits on awards to all director beneficiaries," and the actual awards granted fell within those limits. As a result, the Court of Chancery found that the stockholder approval of the plan was sufficient to allow defendants to invoke a ratification defense.

The Delaware Supreme Court reversed the Court of Chancery's decision, holding that the discretion granted to directors in the equity plan to approve specific awards precluded the stockholder ratification defense. Consequently, the Delaware Supreme Court found that the grants were "self-interested decisions" and subject to the entire fairness standard of review.

According to the Delaware Supreme Court, ratification is a permissible defense in only two scenarios: (1) when stockholders approve specific director awards and (2) when the equity plan is a self-executing formula plan, such that the directors have no discretion in granting the awards to themselves. If directors retain discretion to make awards under the general parameters of a plan—even when the parameters are specific to directors—then ratification cannot be used to foreclose a breach of fiduciary duty claim.