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Client Alert

The Delaware Supreme Court Eliminates the Defense of Stockholder Ratification to Director Compensation Decisions Made Pursuant to Discretionary Equity Incentive Plans

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In its December 2017 decision, *In re Investors Bancorp, Inc. Stockholder Litigation*,[2] the Delaware Supreme Court revived claims challenging director compensation decisions a board made pursuant to a stockholder-approved, discretionary equity incentive plan that included beneficiary-specific limits. In reversing the Court of Chancery's decision to dismiss those claims, the court held: "[W]hen it comes to the discretion directors exercise following stockholder approval of an equity incentive plan, ratification cannot be used to foreclose the Court of Chancery from reviewing those further discretionary actions when a breach of fiduciary duty claim has been properly alleged."[3] In so holding, the Supreme Court uprooted a nearly 20 year-old line of Court of Chancery precedents that have recognized the ratification defense as a bar to claims against directors for compensation decisions made pursuant to an equity plan that meaningfully cabins their discretion.

A refresher on how ratification works under Delaware law is useful. Under Delaware law, self-interested board decisions are not reviewed under the deferential business judgment rule standard, but rather, the more exacting entire fairness standard. The more deferential business judgment rule will apply to a review of a self-interested decision, however, if it has

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[2] 2017 WL 1277672 (Del. Ch. Apr. 5, 2017) (Slights, V.C.), *rev'd* --- A.3d ---, 2017 WL 6374741 (Del. Dec. 13, 2017, *as revised* Dec. 19, 2017).

[3] 2017 WL 6374741, at *11.

been ratified by stockholder approval. Insulating a self-interested decision by the business judgment rule has a powerful effect: it protects the decision from stockholder challenge on any ground other than corporate waste, a near unreachable bar for liability.[4] And "the vestigial waste exception has long had little real world relevance, because it has been understood that stockholders would be unlikely to approve a transaction that is wasteful."[5]

Because director compensation decisions involve directors deciding how and how much to compensate themselves, those decisions are typically self-interested board decisions and thus subject to review under the entire fairness standard unless they have been ratified. A board can establish a ratification defense for a specific equity incentive award by obtaining approval of independent and disinterested stockholders of the specific compensation award at issue,[6] typically through a fully informed stockholder vote.[7] A board can also establish a ratification defense for equity incentive plans that are self-executing, "meaning plans that make awards over time based on fixed criteria, with the specific amounts and terms approved by the stockholders" and which "require[] no discretion by the directors."[8] *Investors Bancorp* affirmed that both of these options—stockholder approval of a specific

[4] *See Singh v. Attenborough,* 137 A.3d 151, 152 (Del. 2016) (ORDER) (citing *Harbor Fin. P'rs v. Huizenga*, 751 A.2d 879, 881-82 (Del. Ch. 1999)). A stockholder is also free to challenge the ratifying vote as uninformed or coercive, but such challenges are generally difficult, and increasingly uncommon under Delaware law, particularly in the context of director compensation decisions.

[5] *Id.*

[6] *See, e.g.*, *Cambridge Ret. Sys. v. Bosnjak*, 2014 WL 2930869, at *7-8 (Del. Ch. June 26, 2014).

[7] Stockholder action may also be taken by written consent under Delaware law, *see generally Espinoza v. Zuckerberg*, 124 A.3d 47 (Del. Ch. 2015), although there are often collective action difficulties with this approach in the publicly traded company context.

[8] *Investors Bancorp*, 2017 WL 6374741, at *1, *7; *see also id.* at *6-8 (discussing *Kerbs v. Cal. E. Airways, Inc.,* 90 A.2d 652 (Del. 1952), *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660 (Del. 1952), *reargument denied*, 91 A.2d 57 (Del. 1952), *Steiner v. Meyerson*, 1995 WL 441999 (Del. Ch. July 19, 1995), *Lewis v. Vogelstein*, 669 A.2d 327 (Del. Ch. 1997)).

compensation award and the enactment of a self-executing compensation plan—remain viable ways to ratify director compensation decisions.[9]

At issue in *Investors Bancorp*, however, was the effectiveness of a ratification defense as to a third and more nettlesome director compensation decision—board implementation of a stockholder-approved *discretionary* equity incentive plan in which "directors retain discretion to make awards under the general parameters" of the plan.[10] The Delaware Supreme Court has not had the occasion to directly address this issue since 1952, but the Court of Chancery has grappled with the question of the ratifying effect of stockholder-approved discretionary plans in the last two decades.

The Court of Chancery first recognized the ratifying effect of stockholders approving a discretionary plan in 1999 in *In re 3COM Corp Shareholders Litigation*.[11] There, the court upheld a ratification defense where the equity incentive plan at issue set upper limits on the amount of equity that could be awarded, thereby sufficiently limiting the directors' discretion to make awards under the plan.[12] The next year, the Court of Chancery decided *Criden v. Steinberg* giving ratifying effect to stockholders' approval of an equity incentive plan that gave the board broader discretion than the plan at issue in *3COM*.[13] Then, in 2007, the court rejected the ratification defense in *Sample v. Morgan*—a case wherein plaintiff challenged substantial equity grants to directors under a stockholder-approved equity incentive plan, alleging that the plan was "designed to entrench the Company under the then-current management and massively dilute the equity interests of the public holders to the benefit of management."[14] Refusing to give insulating effect to the stockholder vote, the court emphasized that the limits of the plan were insufficiently defined—in that the plan

[9] 2017 WL 6374741, at *10.

[10] *Id.*

[11] 1999 WL 1009210 (Del. Ch. Oct. 25, 1999).

[12] *Id.* at *2-3.

[13] 2000 WL 354390 (Del. Ch. Mar. 23, 2000).

[14] 914 A.2d 647, 659 (Del. Ch. 2007).

authorized a total number of shares to be awarded, but set no parameters for awarding the shares.[15] The court observed that the "Delaware doctrine of ratification does not embrace a 'blank check'" theory."[16] In the 2012 *Seinfeld v. Slager* decision, the court rejected another ratification defense for a stockholder-approved discretionary plan with similarly undefined limits—distinguishing the broad limits of the plan under consideration from the prescribed limits of the plan in *3COM*.[17] The court held that, where the equity incentive plan at issue is discretionary, to support a ratification defense, the plan must have "some *meaningful* limit," contain "sufficiently defined terms," and cannot "*carte blanche*" authorize directors to engage in their own compensation decisions.[18]

The development in Delaware law signaled by *Seinfeld*, coupled with a market trend to increase non-employee director compensation,[19] inspired a wave of derivative lawsuits challenging non-employee director compensation decisions. In one such suit, *Calma on Behalf of Citrix Systems, Inc. v. Templeton* ("*Citrix*"),[20] the court rejected the directors' argument that the stockholders' approval of an equity compensation plan was sufficient to invoke business judgment deference for non-employee compensation awards.[21] The *Citrix* decision clarified that for stockholder-approval of equity incentive plans to insulate non-employee director compensation decisions, generic limits for all categories of beneficiaries are insufficient and such plans must include limits specific to non-employee directors to invoke business judgment deference.[22]

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[15] *Id*. at 663-64.

[16] *Id.* at 663.

[17] 2012 WL 2501105, at *11-12 (Del. Ch. June 29, 2012).

[18] *Id.* at *12 (emphasis original).

[19] *See Trends in Board of Director Compensation*, Harv. Law Sch. F. on Corp. Governance and Fin. Reform (Apr. 13, 2015), *available at https://corpgov.law.harvard.edu/2015/04/13/trends-in-board-of-director-compensation/*.

[20] 114 A.3d 563 (Del. Ch. 2015).

[21] *Id.* at 589.

[22] *Id.* at 578-79, 586-87.

Following *Citrix*, many of the derivative suits filed in reaction to *Seinfeld* settled.[23] In the settlements, corporations agreed to include beneficiary-specific compensation limits in their equity incentive plans,[24] strengthen compensation committee mandates including by requiring such committees to employ outside compensation consultants to benchmark

[23] *See, e.g.*, *Calma on Behalf of Citrix Sys., Inc. v. Templeton*, C.A. No. 9579-CB (Del. Ch. Sept. 9, 2016) (TRANSCRIPT) ("*Citrix* Tr.") (Bouchard, C.) (approving settlement including limits on equity compensation grants subjected to stockholder approval, strengthened mandate for the compensation committee, required consultation with independent compensation consultant, and enhanced disclosures; granting $425,000 in attorneys' fees for benefits achieved); *Steinberg on Behalf of Celgene Corp. v. Casey*, C.A. No. 10190-CB (Del. Ch. Dec. 9, 2015) (TRANSCRIPT) ("*Celgene* Tr.") (Bouchard, C.) (approving settlement involving a $475,000 equity cap, strengthened mandate for the compensation committee, including an annual review and assessment of all non-employee director compensation and the engagement of an independent compensation consultant tasked with advising the compensation committee as to the amount and type of non-employee director compensation, and enhanced public disclosures; granting $500,000 in attorneys' fees for benefits achieved); *Espinoza on Behalf of Facebook, Inc. v. Zuckerberg*, C.A. No. 9745-CB (Del. Ch. March 30, 2016) (TRANSCRIPT) (Bouchard, C.) (approving settlement requiring formal stockholder approval of two specific proposals on compensation for non-employee directors and implementing, for five years following approval of the settlement, a set of corporate governance reforms that strengthen the compensation committee mandate and improve board approval and oversight; granting $525,000 in attorneys' fees for benefits achieved); *Smith on behalf of Peregrine Pharmaceuticals, Inc. v. King*, C.A. No. 8994-VCL (Del. Ch. July 27, 2017) (TRANSCRIPT) ("*Peregrine* Tr.") (Laster, V.C.) (involving claims challenging an award of stock options to the company's CEO in excess of the stockholder-approved compensation plan, awards of options to both executive and non-employee directors spring-loaded to benefit from a meaningful increase in the stock price putting all of the options in the money, and excessive compensation awarded to the non-employee directors for multiple years, and concerning misleading disclosures on these issues) (approving settlement that included a $1.5 million payment to the company from the CEO and corporate governance reforms, including a two-year cap on non-employee director compensation and the hiring of an independent compensation consultant to provide advice and counsel, which will be disclosed to stockholders).

[24] Informing future settlements, in *Celgene*, Chancellor Bouchard expressed concern regarding a settlement that capped equity, but not cash components, of non-employee director compensation. *See Celgene* Tr. at 5:4-7 ("obviously if you cap one thing but you have flexibility on another, there can be leakage"), 35:15-16 ("There's leakage potentially on the cash compensation side.").

board compensation against that of peer groups, and to enhance disclosures made concerning board compensation decisions.[25]

In addition, following *Citrix*, Institutional Shareholder Services ("ISS") (a prominent proxy advisory service) updated its 2017 proxy voting guidelines to include standards for evaluating proposals to ratify director compensation programs and revise its policy on reviewing equity plans for non-employee directors.[26] As a consequence, many corporations amended their equity incentive plans to include non-employee director-specific limits.[27]

Thus, post-*Citrix*, many corporate practitioners came to believe that stockholder approval of a discretionary equity incentive plan that contained meaningful limits specific to the covered beneficiaries would support a ratification defense. But even after the practical guidance provided by court-approved post-*Citrix* settlements, what constitutes "meaningful," beneficiary-specific limits remained an open issue that no case had directly addressed. Because *Investors Bancorp* was the first case following *Citrix* to review ratification of an equity incentive plan, it was closely watched by corporate practitioners seeking further

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[25] *Id.* Both Chancellor Bouchard and Vice Chancellor Laster have commented positively concerning the value of the outside compensation consultant, coupled with the requirement that the consultants' recommendations be disclosed to stockholders. *See Citrix* Tr. at 21:8-14 ("I think more importantly are the aspects of the settlement where there's an assurance that there will be an independent consultant that's going to come in, that the analysis of that consultant is going to be done on an annual basis, and that that analysis will be disclosed to shareholders."); *Peregrine* Tr. at 26:2-7 ("It is hard to value the other corporate governance enhancements, such as the compensation consultant, but I do think that that is likely to be helpful . . . .").

[26] *See Americas, U.S.,Canada, and Latin American Proxy Voting Guidelines Updates, 2017 Benchmark Policy Recommendations*¸ Inst. S'holder Servs. (Nov. 21, 2016), *available at https://www.issgovernance.com/file/policy/2017-americas-iss-policy-updates.pdf. See also* Lyuba Goltser and Megan Pendleton, *2017 Proxy Season: ISS and Glass Lewis Update their Voting Policies*, Harv. Law Sch. F. on Corp. Governance and Fin. Reg. (Nov. 30, 2016), *available at https://corpgov.law.harvard.edu/2016/11/30/2017-proxy-season-iss-and-glass-lewis-update-their-voting-policies/*.

[27] *See The ClearBridge 100 Report: Non-Employee Director Compensation 2017*, at 10 (Jan. 2017), *available at https://www.clearbridgecomp.com/our-point-of-view-research-studies/clearbridge-100-report-non-employee-director-compensation*.

guidance on what qualifies as "meaningful," beneficiary-specific limits sufficient to support a ratification defense.

Making *Investors Bancorp* particularly significant was the broad discretion that the plan at issue afforded the board. The plan reserved 30,881,296 shares of the company's common stock for restricted stock awards, restricted stock units, incentive stock option, and non-qualified stock options for the Company's officers, employees, non-employee directors, and service providers.[28] Hewing to the ruling in *Citrix*, the plan imposed specific limits on awards to non-employee directors, albeit generous ones, allowing non-employee directors up to 30% of all option and restricted stock shares in any calendar year.[29] Shortly after the plan's approval, the board's compensation committee met four times to determine the specific awards that would be granted to both employee and non-employee directors,[30] awarding nearly half of the options available to the directors and nearly 30% of the shares available to the directors in restricted stock awards.[31] In total, the awards were valued at approximately $51.5 million.[32] On average, each non-employee director was awarded more than $2.1 million, which the plaintiff alleged exceeded Investors Bancorp's historical non-employee director awards and the median pay for non-employee directors at peer and much larger companies.[33] The compensation granted to employee directors was also disproportionate when compared to historical and peer group awards.[34]

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[28] 2017 WL 6374741, at *3-4, *11.

[29] *Id.*

[30] *Id.* at *4-5.

[31] *Id.* At *12.

[32] *Id.* at *5.

[33] *Id*. at *12. Adding another wrinkle to the facts: although the disclosures to stockholders accompanying the plan created the impression that the plan was intended to reward future performance, not past services, the plaintiffs alleged that the awards were for past services, including amounts already accounted for in determining the past year's compensation package. *Id.* at *12.

[34] *Id*. at *12.

Despite the broad discretion afforded by the *Investors Bancorp* plan at issue, in April 2017, the Court of Chancery dismissed the complaint. Vice Chancellor Slights held that the equity incentive plan contained meaningful and specific limits, though generous ones, on the compensation any member the board would receive, and the stockholders approved the plan.[35] Accordingly, because the awards were within the bounds of those limits, the plan would be subject to business judgment deference—and therefore would be immune from challenge, absent a showing of waste.[36] Plaintiffs failed to plead waste, and thus the claim was dismissed.[37]

The Delaware Supreme Court reversed the Court of Chancery's ruling. Following a deep analysis of Delaware law concerning ratification defenses in the context of employee compensation decisions,[38] the court concluded that the doctrine of ratification does not shield a board's self-interested decision concerning compensation awards made pursuant to a discretionary plan from judicial review.[39] Citing to *Sample*, the court reasoned that the directors' discretion under an equity incentive plan must be exercised consistent with their fiduciary duties.[40] Having eliminated the defense of stockholder ratification, the court concluded that the facts alleged created a "pleading stage reasonable inference that the

[35] *See Investors Bancorp*, 2017 WL 1277672, at *8 (disagreeing with plaintiff's characterization of the EIP and stating that the directors did not grant themselves "blank check" authority to award themselves any amount of compensation they desired).

[36] *Id.*

[37] *Id.* The Court of Chancery likewise rejected the plaintiff's disclosure arguments. The plaintiff argued that the board's quick action granting the compensation awards after stockholder approval of the plan implied that the board misrepresented its intentions in adopting the plan. Based on the proxy disclosures, the court concluded that the stockholders knew that once the plan was approved, the board was authorized to make awards pursuant to the plan immediately. *See id.* at *9-10.

[38] 2017 WL 6374741, at *6-11.

[39] *Id.* at *11.

[40] *Id.*

directors breached their fiduciary duties in making unfair and excessive discretionary awards[.]"[41]

Thus, what began as litigation concerning a fairly limited issue framed by post-*3COM* Court of Chancery decisions—i.e., what constitutes meaningful, beneficiary-specific limits—resulted in the Delaware Supreme Court's reevaluating the holding of *3COM* and its progeny, and ultimately disallowing the ratification defense to claims challenging director compensation decisions made under discretionary plans.

The *Investors Bancorp* reversal could have wide-sweeping ramifications. On the one hand, it is likely to affect the ISS recommendations concerning director compensation issues, adopted in part in reaction to the post-*3COM* decisions concerning this issue. Further, it calls into question the value some of the therapeutic benefits achieved in the post-*Citrix* settlement, such as cash and equity compensation limits. Importantly, it could also affect the significant number of Delaware corporations with discretionary equity incentive plans who were previously eligible for ratification defenses to any challenge to director compensation. If corporations relied on the discretionary plan to insulate director compensation awards by the business judgment rule, then, to a degree, they are back to the drawing board, and must reevaluate their system for director compensation awards in light of the risks of litigation. On the other hand, the post-*Citrix* settlements provisions and ISS recommendations have arguably resulted in more reasonable and defensible equity incentive plans and board decisions made pursuant thereto. Thus, what, if any, increased exposure of risk to liability corporations and board will face from this doctrinal shift is yet to be seen.

[41] *Id.* at *13.