



INSIGHTS

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■ DIRECTOR COMPENSATION

The Delaware Court of Chancery Revisits Director Equity Awards

The Delaware Court of Chancery recently held that stockholder approval of an equity incentive plan that included relatively broad sub-limits on the number of shares available specifically for awards to non-employee directors provided “advance ratification” of subsequent awards to the non-employee directors. The Court’s opinion provides significant guidance to corporations and practitioners in drafting and seeking stockholder approval of equity incentive plans, and in defending against challenges to awards made to directors under stockholder-approved plans.

By John Mark Zeberkiewicz
and Stephanie Norman

In *In re Investors Bancorp, Inc. Stockholders Litigation*,¹ the Delaware Court of Chancery granted the director-defendants’ motion to dismiss the plaintiffs’ claims challenging “quite large”² equity incentive awards made to the company’s non-executive directors. Following the “settled guidance”³ from

*In re 3COM Shareholders Litigation*⁴ and *Calma v. Templeton*,⁵ the Court held that, although the board’s decision would by default be subject to review under the rigorous entire fairness standard, the stockholders’ approval of the equity incentive plan pursuant to which the awards were made was sufficient to provide “advance ratification” of the awards, thereby restoring the presumption of the business judgment rule. That the sub-limits for non-employee directors were included in an “omnibus plan” that allowed for awards to multiple types of recipients, rather than in a director-specific plan, was of no moment.

As the plan contained “meaningful, specific limits on awards to all director beneficiaries,” and the stockholders “were advised of the magnitude” of the awards the directors could grant themselves,⁶ the Court declined the plaintiffs’ invitation to engage in judicial second-guessing of an informed vote of stockholders.⁷ Even though the awards were sizable in relation to awards to directors in the company’s self-identified peer group, they were well within the plan’s applicable sub-limits, and the plaintiffs had not established that they were so exorbitant as to constitute waste.

The Court also dismissed the plaintiffs’ claims challenging the board’s approval of awards to two executive directors, holding that the plaintiffs had not adequately pled demand futility.⁸ In this connection,

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the Court rejected the plaintiffs' argument—intended to create doubt as to the independence and disinterestedness of a majority of the board—that the grants to the executive directors were made as part of a “quid pro quo” for the non-executive director grants.⁹

The Court's opinion provides significant guidance to corporations and practitioners in drafting and seeking stockholder approval of equity incentive plans, and in defending against challenges to grants made to directors under stockholder-approved plans. Corporations and practitioners are cautioned, however, that the Court's decision has been appealed to the Delaware Supreme Court and that the matters addressed in the opinion are accordingly subject to further development.

Background

Investors Bancorp, Inc. (Company) was the successor, through a 2013 “mutual-to-stock” reorganization transaction, of a corporation bearing the same name. Following the reorganization, the Company's board of directors (Board) was composed of twelve directors, consisting of ten non-employee directors who served along with the Company's Chief Executive Officer and its Chief Operating Officer. The Board fixed director and officer compensation based on recommendations from the compensation committee of the Board (Compensation Committee), which consisted of seven non-employee directors.

The proxy statement for the meeting disclosed the key features of the Plan.

In 2014, each non-employee director received compensation consisting principally of a fixed monthly cash retainer and per-meeting board and committee fees. Total compensation for non-employee directors in 2014 ranged from approximately \$97,000 to \$207,000, with an average of approximately \$133,000.¹⁰ In addition, in 2014, the Company's Chief Executive Officer (CEO) and Chief Operating

Officer (COO) received compensation packages valued at a total of \$2,778,700 and \$1,665,794, respectively, each package consisting of a base salary, a cash incentive award contingent on the satisfaction of performance goals, and other perquisites.

In December 2015, at a meeting to address compensation amounts for the upcoming year, the Compensation Committee received a report from its consultant showing that the Company's non-employee director compensation was in line with the practices of the 18 companies identified as being within its peer group. Consistent with the presentation, the Compensation Committee recommended maintaining the existing compensation arrangements for non-employee directors (other than to provide a modest increase to the per-meeting committee fees). In addition, with input from its consultant, the Compensation Committee recommended that the Board maintain the base salaries of the CEO and COO, but provide an increase to the cash incentive component of their pay packages.

In March 2015, the Board approved the Company's 2015 Equity Incentive Plan (Plan). The Plan reserved a total of nearly 31 million shares—representing more than eight percent of the Company's then outstanding common stock¹¹—for various types of equity-based awards, including stock options and restricted stock units, to the Company's officers, employees, non-employee directors, and service providers. The Plan included various sub-limits, capping the total number of shares that could be issued as stock options and restricted stock units, as well as the total number of shares that could be issued to employees and directors. Specifically, the Plan provided that a maximum of 4,411,613 shares could be issued to any single employee pursuant to stock options and that a maximum of 3,308,710 shares could be issued to any single employee as restricted stock or restricted stock units. The Plan also provided that up to 30 percent of the shares available for option or restricted stock grants under the Plan were available to be awarded to all non-employee directors, and that awards in respect of all such shares could be made in a single year.

The Plan was submitted to stockholders at the Company's 2015 annual meeting and was approved by nearly 96 percent of the shares voted, representing nearly 80 percent of the outstanding stock. The proxy statement for the meeting disclosed the key features of the Plan, including its purpose as well as its key limits and sub-limits. The proxy statement included no indication as to the specific number of shares that would be awarded to non-employee directors under the Plan in any particular year, stating instead that the number and type of awards would remain subject to the Compensation Committee's discretion and would not be determined finally until after the stockholder vote on the Plan.

Shortly after the stockholders' adoption of the Plan, the Compensation Committee convened a series of meetings to consider the amount of equity incentive awards it was willing to recommend. During the course of these meetings, the Compensation Committee received reports from its compensation consultant with respect to the number of stock options and restricted stock awards granted to non-employee directors and officers of companies that, like the Company, had undergone a mutual-to-stock reorganization transaction. At a meeting held on June 19, 2015, the Compensation Committee received a proposal from the CEO with respect to the number of options and shares of restricted stock to be awarded to the CEO and the COO. In a session that followed, the members of the Compensation Committee indicated their concurrence with the CEO's recommendations and, focusing on the Plan's specific sub-limits for awards to non-employee directors, made recommendations with respect to option and restricted stock awards for the non-employee directors.

At a meeting on June 23, 2015, the Board approved option and restricted stock awards to all directors (including the executive directors) that, in the aggregate, had a grant-date value of more than \$51 million. The non-employee directors (other than the chairman and lead director) received awards valued at approximately \$2 million; the chairman and the lead director received awards valued at

approximately \$2.6 million; and the CEO and COO received awards valued at approximately \$16.7 million and \$13.3 million, respectively. All of the awards were within the Plan's applicable sub-limits. Following the public announcement of the equity awards in the proxy statement for the 2016 annual meeting, three separate complaints were filed in the Delaware Court of Chancery, all alleging breach of fiduciary duty in connection with the allegedly excessive awards. The defendants moved to dismiss, arguing that the plaintiffs had failed to state a claim for which relief could be granted and, with respect to the awards to the executive directors, had failed to make a pre-suit litigation demand.¹²

Analysis of the Non-Executive Director Grants

In reviewing the plaintiffs' claims in respect of the non-employee director grants, the Court proceeded from the premise that, because every member of the Board who made the decision to grant the awards received a special benefit from the decision, "entire fairness [would be] the default standard of review."¹³ Thus, to overcome the application of the entire fairness standard and prevail on their motion to dismiss, the defendants would have to establish that the stockholders' approval of the Plan had the effect of ratifying the awards, in which case the Board's decision would be subject to the presumption of the business judgment rule, reviewable only for waste.¹⁴

In response to the affirmative defense, the plaintiffs raised three principal arguments. First, they claimed that because the Plan included neither a "self-executing" feature (*i.e.*, one that would provide for fixed amounts of awards to the non-employee directors, with no discretion on the part of the Board to provide for increases or enhancements) nor "meaningful limits" on the amount of awards, the stockholders' adoption of the Plan was not effective to ratify the awards. Second, the plaintiffs claimed that, despite the absence of meaningful limits on the amount of non-employee director awards in the Plan, the Board could have sought (but declined to

seek) stockholder approval of the specific grants. Finally, the plaintiffs claimed that the stockholders' ratification of the Plan was of no consequence, as the Board had failed to disclose all material information regarding the Plan when seeking stockholder approval.¹⁵

The Effect of Stockholder Ratification of the Plan

Addressing the defendants' ratification defense, the Court noted that the doctrine of stockholder ratification "derives from the recognition in agency law that a principal may confer upon the agent authority to act 'in circumstances in which the agent had no authority or arguably had no authority,'" and that informed stockholder consent to director compensation arrangements would insulate the decisions from all challenges other than waste.¹⁶ While noting that the plaintiffs did not dispute the notion that stockholder ratification would insulate the grants from attack (other than waste), the Court addressed the plaintiffs' argument that the Plan's lack of a self-executing feature or meaningful limits eviscerated any ratification defense.¹⁷

The plaintiffs advanced an expansive reading of *Calma v. Templeton*, where the central issue was

whether advance stockholder approval of a compensation plan with multiple classes of beneficiaries and a single generic limit on the amount of compensation that may be awarded in a given year is sufficient to establish a ratification defense

for the awards granted to non-employee directors.¹⁸ The *Calma* Court concluded that the stockholders' adoption of "the broad parameters" of a stockholder-adopted plan that covered multiple beneficiaries and had no specific limits on the magnitude of awards to non-employee directors was insufficient to provide ratification of the specific subsequent grants to the non-employee directors.¹⁹ The *Calma* Court accordingly determined to apply the entire fairness standard of review to the grants at issue.²⁰

Rejecting the plaintiffs' *Calma*-based arguments, the *Bancorp* Court noted that the decision in *Calma* was derived, by distinction, from the holding in *In re 3COM Shareholders Litigation*, where the central question (as in *Calma*) was whether "directors commit waste and breach their fiduciary duty of loyalty when they receive stock options approved under a plan endorsed in advance by shareholder vote."²¹ The *3COM* Court concluded that the stockholders' adoption of the plan was sufficient to provide "advance ratification" of the grants to the non-employee directors.²² As a result, the *3COM* Court did not view the case as one involving "directors independently or unilaterally granting themselves stock options," but as one in which "stock options accrued to these directors under the terms of an established option plan with sufficiently defined terms" that were "knowingly set" by the stockholders.²³

The plaintiffs in *Bancorp* sought to distinguish the holding in *3COM* on the grounds that *3COM*'s equity incentive plan applied only to directors, and was not, unlike the Company's Plan, an omnibus plan covering grants to multiples classes of beneficiaries, including employee, officers, and directors.²⁴ Moreover, they argued that the limits on awards to directors in *3COM*'s plan were far narrower than those in the Company's Plan.²⁵ Due to these alleged deficiencies in the Company's Plan, the plaintiffs argued, there was no "meeting of the minds" as to the scope of subsequent director awards purportedly ratified through the stockholders' adoption of the Plan.²⁶

The Court found the plaintiffs' arguments unavailing. First, the Court disagreed with the plaintiffs' argument regarding the omnibus nature of the Plan.²⁷ Whether the plan is an omnibus plan or a director-specific plan, "the key point," according to the Court, "is the specific focus on the limit or limits imposed on awards to various beneficiaries of the plan."²⁸ Second, the Court rejected the argument that the Company's Plan should be distinguished from *3COM*'s plan on the grounds that the latter included specific limits on different types of board service, while the former set limits on grants to *all* non-employee directors and *all*

executive directors, each viewed in the aggregate.²⁹ According to the Court, the plaintiffs were making a “distinction without a difference.”³⁰

Once the plan sets forth a specific limit on the total amount of options that may be granted under the plan to all directors, whether individually or collectively, it has specified the “director-specific ceilings” that [the *Calma* Court] found to be essential when determining whether stockholders also approved in advance the specific awards that were subsequently made under the plan.³¹

Notably, although the Court disagreed with the plaintiffs’ arguments regarding the Plan’s lack of a self-executing grant feature, it did note that, had such arrangements been in place, “there would be no room to dispute that subsequent awards would be subject to business judgment review.”³²

The Court concluded that the Board, in seeking stockholder approval of the Plan, was not seeking a “blank check” on awards to directors.³³ The Court observed that the stockholders, when approving the Plan, were advised of the magnitude of the total amount of shares available for option and restricted stock awards generally, as well as the total amount of shares available for option and restricted stock awards to non-employee directors specifically.³⁴ Despite the relatively broad range of the shares available for awards to non-employee directors, the Court determined that the Plan was distinguishable from the plan at issue in *Calma*. The plan in *Calma* contained a “generic” aggregate limit of one million shares, with no sub-limits for participants based on their particular position.³⁵ The Company’s Plan, by contrast, contained specific sub-limits for specific classes of participants, including specified individual participants, and the sub-limits varied by position.

As the grants to the non-employee directors were made within the confines of the specific sub-limits in the stockholder-approved Plan, the Board’s decision to make the grants was reviewable only for waste, which the plaintiffs had not pled.³⁶ Accordingly, the

Court dismissed the plaintiffs’ claims challenging the non-employee director grants.

Fully Informed Vote on the Plan

The Court next considered the plaintiffs’ argument that the stockholders’ approval of the Plan should be given no effect for purposes of ratifying the non-employee director grants since the vote was not fully informed. Specifically, the plaintiffs alleged that the disclosure in the Company’s 2015 proxy statement was materially misleading in that it stated that the purpose of the Plan was to serve “‘as a compensation vehicle for all of the Company’s nearly 1,800 employees, officers, and non-employee directors,’” but it failed to disclose that the Board had “‘timed the implementation of the [Plan] to avoid restrictions imposed by the [Federal Reserve Board]’” in connection with its preconceived plan to use a significant portion of the Plan’s available shares to allocate awards to themselves as a reward for the Company’s mutual-to-stock reorganization transaction.³⁷ That the disclosure regarding the Plan included statements to the effect that the Board had not yet determined the number of shares that would be granted to the non-employee directors, according to the plaintiffs, served only to bolster their disclosure-based claims.³⁸

The Court rejected the disclosure-based claims.³⁹ The Court noted that the Plan was submitted to the stockholders at the first annual meeting following its adoption by the Board; the annual meeting date, and not the Board’s alleged manipulation, drove the timing of adoption.⁴⁰ In addition, the Court noted that the plaintiffs had acknowledged that the Compensation Committee and the Board held a series of meetings following the Plan’s adoption at the annual meeting to determine the number of option and restricted stock grants that would be made, yet the plaintiffs had not pled specific facts demonstrating the existence of a preconceived plan.⁴¹ That the meetings to determine the awards occurred shortly after the annual meeting was not sufficient, of itself, to support a reasonable inference that a preconceived plan had been put in place.⁴²

Analysis of the Executive Director Grants

The Court next addressed the defendants' motion to dismiss the claims as to the executive director awards on the grounds that the plaintiffs had failed to make a pre-suit litigation demand and had not adequately pled demand futility. The plaintiffs' argued that they had adequately pled demand futility, asserting that the awards to the executive directors were part of a "unitary transaction," with the grants to the executive directors serving as a "quid pro quo" for the grants to the non-employee directors.⁴³

Disputing this contention, the defendants pointed to the fact that the Board consisted of twelve directors, only two of whom were executive directors, and that the executive directors' votes on the non-employee director awards were not necessary for their authorization.⁴⁴ The Court agreed with that analysis, and made the further observation that, even if the plaintiffs were not required to show that the votes of the executive directors were needed for the authorization of the non-employee director awards, they would still be required to plead facts from which a reasonable inference could be drawn that the non-employee directors received a special benefit in exchange for their approval of the awards to the executive directors.⁴⁵ Because the non-employee director awards were within the parameters of the stockholder-approved Plan, no such special benefit could be shown.⁴⁶

As the plaintiffs were unable to plead facts supporting an inference that the Board had engaged in an improper transaction sufficient to raise a reasonable doubt as to the independence or disinterestedness of a majority of the Board, the Court dismissed the plaintiffs' claims as to the executive director grants on the grounds that they had failed to make a demand on the Board or to adequately plead demand was futile.

Key Takeaways

Following the Court of Chancery's 2015 opinion in *Calma*, corporate practitioners considered

whether it would be advisable to include non-executive director equity incentive arrangements in a separate plan, rather than in an omnibus plan. While there may be valid reasons to do so that are unrelated to the effect of stockholder ratification, the *Bancorp* Court made clear that the key issue is not whether the corporation maintains a separate plan for non-employee directors, but rather whether the stockholder-adopted plan deals separately with, and contains separate sub-limits for, non-employee directors.

In addition, following *Calma*, corporate practitioners considered whether corporations should structure their equity incentive plans (or amend their existing plans) to provide for self-executing grants for non-executive directors or to set forth narrow ranges for grants to individual non-executive directors. The *Bancorp* opinion suggests that a plan's sub-limits for grants to non-employee directors need not necessarily be within severely constrained metes and bounds, so long as the stockholders approve the plan in a fully informed vote. Despite the *Bancorp* Court's holding, given the current lack of guidance from the Delaware Supreme Court on the point, prudence may still counsel in favor of structuring plans to provide for self-executing grants or to impose narrow limits on awards to non-employee directors. To this point, the *Bancorp* Court itself noted that where a stockholder-adopted plan includes a "self-executing" grant feature, the stockholders' approval of the plan will result in the ratification of any self-executing awards.

In addition, although the Board's process in approving the grants was not squarely at issue, the Court's opinion provides guidance on the importance of engaging outside consultants and advisors and ensuring that compensation decisions are the result of a thorough, deliberate and well-documented process. In this regard, the apparent strength of the Compensation Committee's and the Board's processes in reviewing and ultimately approving the grants at issue—including the fact that they conducted a series of formal meetings and adequately documented the proceedings—was a critical factor in rebutting the

plaintiffs' claims regarding whether the stockholders' vote to adopt the Plan was fully informed.

Notes

1. 2017 WL 1277672 (Del. Ch. April 5, 2017).
2. *Id.* at *8, n. 33.
3. *Id.* at *1.
4. 1999 WL 1009210 (Del. Ch. Oct. 25, 1999).
5. 2015 WL 2265535 (Del. Ch. Apr. 30, 2015).
6. *Bancorp*, 2017 WL 1277672, at *8.
7. *Id.*, at *8, n. 33.
8. *Id.* at *8.
9. *Id.*
10. *Id.*
11. *Id.*
12. *Investors Bancorp, Inc.*, Proxy Statement (Schedule 14A), at 2 (April 30, 2015) ("On April 20, 2015, 352,296,228 shares of Investors Bancorp common stock were outstanding and held by approximately 18,000 holders of record.").
13. *Bancorp*, 2017 WL 1277672, at *6. As to the application of entire fairness in this context, the Court in *Calma* explained: "Delaware courts examine the merits of a claim for breach of fiduciary duty through one of (primarily) three doctrinal standards of review: business judgment, enhanced scrutiny, and entire fairness. Where a stockholder cannot rebut the presumptive business judgment standard, the stockholder must show that the board's decision cannot be attributed to any rational business purpose—which, in effect, is the standard for waste under Delaware law. But, where a stockholder rebuts the business judgment standard—for example, by establishing that at least half of the directors who approved a business decision are not independent or disinterested—the Court reviews the directors' decision under the entire fairness standard, in which case the directors must establish 'to the court's satisfaction that the transaction was the product of both fair dealing and fair price.'" *Calma*, 2015 WL 2265535, at *8 (footnotes omitted).
14. See *Gottlieb v. Heyden Chem. Corp.*, 91 A.2d 57, 58 (Del.1952) (noting, where a stockholder ratification vote has been obtained, the stockholder plaintiff's burden is to demonstrate "that no person of ordinarily sound business judgment would be expected to entertain the view that the consideration furnished by the individual directors is a fair exchange for the options conferred").
15. *Investors Bancorp*, 2017 WL 1277672, at *6.
16. *Id.* (citing *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997)).
17. *Investors Bancorp*, 2017 WL 1277672, at *6.
18. *Calma*, 2015 WL 1951930, at *9.
19. *Id.*
20. *Id.*
21. *3COM*, 1999 WL 1009210, at *1.
22. *Id.* at *3.
23. It was apparently critical to the 3COM Court's analysis that the "strictures" of the plan included specific limits on the number of awards that could be granted that "differ[ed] based on specific categories of service such as service on a committee, position as a lead director, and chairing the Board." *Id.* at *3, n. 9.
24. *Investors Bancorp*, 2017 WL 1277672, at *7.
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.* at *8, n. 26. The Court pointed to *Steiner v. Meyerson*, 1995 WL 441999 (Del. Ch. July 19, 1995), where the stockholders' adoption of a plan with self-executing limits "perforce meant" that the adoption gave rise to a ratification defense.
33. *Investors Bancorp*, 2017 WL 1277672, at *8.
34. *Id.*
35. *Id.*
36. *Id.* at *8, n. 33. The Court stated: "One cannot help but acknowledge that the awards here were quite large. Indeed, Plaintiffs make allegations, which appear well-founded, that the Defendants knew that the compensation they were awarding to themselves was well above the level of compensation of directors at other corporations in the Company's self-identified peer group. This fact alone, however, is not sufficient to subject the awards to entire fairness review. That the awards were large does not mean that stockholders could not approve the amounts in advance through

a fully informed stockholder vote.” *Id.* The Court cited *Corwin v. KKR Financial Hldgs. LLC*, 125 A.3d 304, 312–313 (Del. 2015), for the proposition that the policy of Delaware law is “to avoid the uncertainties and costs of judicial second-guessing when the disinterested stockholders have had the free and informed chance to decide on the economic merits of a transaction for themselves.” While recognizing that there are circumstances in which a grant is so exorbitant that a plaintiff could state a claim for waste, the *Bancorp* Court declined, in the absence of a specific pleading, to use the plaintiffs’ “meaningful limits” argument to second

guess the fully informed vote of the stockholders. *Investors Bancorp*, 2017 WL 1277672, at *8, n. 33.

37. *Id.* at *9.

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.* at *10.

42. *Id.*

43. *Id.* at *11.

44. *Id.*

45. *Id.*

46. *Id.*

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