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DIRECTOR COMPENSATION

The Limits of Ratification: Delaware Supreme Court and Director Equity Incentive Awards

The Delaware Supreme Court recently overturned an opinion of the Delaware Court of Chancery holding that stockholder approval of an equity incentive plan with broad sub-limits on the number of shares available for grant to non-employee directors resulted in the stockholders' ratification of subsequent awards to the directors. In essence, the Supreme Court held that stockholders' approval of an equity incentive plan will provide "advance ratification" of the directors' decisions only where the plan provides for "self-executing" grants in fixed amounts and on specified terms.

By John Mark Zeberkiewicz and Stephanie Norman

In *In re Investors Bancorp, Inc. Stockholders Litigation*,[1] the Delaware Supreme Court reversed the decision of the Court of Chancery granting the director-defendants' motion to dismiss the stockholder-plaintiffs' claims challenging the relatively substantial equity incentive award the directors granted to themselves.[2] In granting the defendants' motion to dismiss, the Court of Chancery had relied upon what it considered the "settled guidance"[3] that the stockholders' approval of an equity incentive plan containing sub-limits on the number of options or shares available for grant to the directors provides "advance ratification" to subsequent awards made within such sub-limits, resulting in the application of the business judgment rule to the directors' decision as to their own compensation. The Delaware Supreme Court recognized the precedent of the Court of Chancery holding that, as a result of the stockholder ratification defense, the business judgment rule applied to the directors' decision to fix their own compensation within the parameters of a plan containing "meaningful limits" on the awards.[4] Nevertheless, the Supreme Court held that, "[h]uman nature being what it is," directors' discretionary decisions as to their own compensation should in the appropriate case be subject to review by the Court of Chancery.[5]

Background

Investors Bancorp, Inc. (Company) is a New Jersey-based bank holding company. In 2014, after a mutual-to-stock conversion, the Company

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conducted a public offering in which it raised approximately $2.15 billion.[6] At that time, the non-employee directors were compensated by a monthly cash retainer, per meeting fees, and perquisites and benefits, with the total amount of compensation ranging from approximately $97,200 to $207,000.[7] Following the consummation of the mutual-to-stock conversion, the Company's Compensation Committee met to fix director compensation for 2015.[8] The Compensation Committee engaged a compensation consultant who presented a report showing that the Company's non-executive director compensation was in line with its peers. After that presentation, the Compensation Committee recommended no changes to the non-executive directors' compensation packages, other than to increase the per-meeting fees from $1,500 to $2,500.[9]

Not long after fixing the 2015 non-executive director compensation, the Company's Board of Directors approved the Company's 2015 equity incentive plan.[10] Under that plan, the Company reserved approximately 30 million shares of common stock for various types of awards, including restricted stock grants, restricted stock units and stock options, for the Company's approximately 1,800 officers, employees, non-employee directors and agents.[11] The plan contained various sub-limits on the number of shares that could be issued or delivered as awards. Of particular relevance, the plan provided that the total number of shares that could be issued or delivered to the non-employee directors pursuant to stock options, restricted stock or restricted stock units would not exceed 30 percent of the total number of shares available for awards as options or restricted stock and that all such shares could be granted in a single calendar year.[12]

The Company submitted the plan to its stockholders for adoption at its 2015 annual meeting.[13] The proxy statement describing the plan stated that "'number, types and terms of awards" made under the plan were subject to the Compensation Committee's discretion and would not be determined until after the stockholders approved the plan.[14] Shortly after the stockholders adopted the plan, the Compensation Committee met to consider awards to non-executive directors.[15] In a series of meetings, the Compensation Committee, with input from its counsel and compensation consultant, reviewed the awards granted to directors of companies that had undergone a mutual-to-stock conversion.[16] Based on the recommendation of the Compensation Committee, the Board approved a grant of awards to the non-employee directors totaling $21,594,000 (and averaging $2,159,400 per non-employee director).[17] According to the plaintiffs, the grant to the non-executive directors was far in excess of the average awards to non-executive directors within the Company's peer group.[18]

Following the announcement of the awards to the non-executive directors, stockholders filed suit challenging the awards as excessive. The defendants moved to dismiss on the basis that the plaintiffs' had failed to state a claim. The Court of Chancery granted the defendants' motion, holding that the stockholders' approval of the plan, which included "meaningful, specific" sub-limits on awards available to the non-employee directors, rather than a single generic limit on awards available to all recipients, served as advance ratification of the subsequent awards.[19] Reviewing the matter *de novo*, the Supreme Court reversed the Court of Chancery's opinion and remanded for further proceedings.

Analysis

The Supreme Court proceeded from the premise that while the board, as a statutory matter, is authorized to fix the compensation of directors, subject to any limitations in the certificate of incorporation or bylaws,[20] all corporate acts are "twice tested"—once at law and again in equity. From an equitable standpoint, where the board is setting its own compensation, it is engaging in a self-interested transaction that ordinarily will not be subject to the presumption of the business judgment rule but will instead be tested under the rigorous entire fairness standard of review.[21] The Supreme Court stated,

however, that a fully informed, uncoerced vote of disinterested stockholders could ratify director self-compensation decisions.

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The Supreme Court noted that it had not addressed specifically the question of stockholder ratification of director self-compensation decisions since *Kerbs v. California Eastern Airways, Inc.*,[22] and *Gottlieb v. Heyden Chemical Corp.*,[23] each of which dates to the early 1950s.[24] Since that time, however, the Court of Chancery had continued to develop the law surrounding director self-compensation. The Supreme Court reviewed its own precedent, noting that in *Kerbs*, it held that stockholder approval of a stock option plan providing for self-executing grants was sufficient to dismiss any claim regarding the stock option plan, unless the board's action was fraudulent, *ultra vires* or constituted waste.[25] In *Gottlieb*, the Supreme Court applied the business judgment rule to claims challenging specific option grants under a stockholder-approved plan under circumstances where the board had announced the names of the recipients, number of shares, price per share and issuance schedule prior to the meeting.[26] The *Gottlieb* Court, however, declined to give effect to the ratification of options subject to future awards, as the stockholders had only approved the general parameters of the awards, and not the specific terms. The Court concluded that, following *Kerbs* and *Gottlieb*, the defense of ratification would apply to plans containing specific awards to directors. But the stockholders' approval of a plan would not operate to ratify " 'specific bargains not yet proposed.' "[27]

The Supreme Court then reviewed earlier cases of the Court of Chancery, such as *Steiner v. Meyerson*[28] and *Lewis v. Vogelstein*,[29] that, consistent with the holdings in *Kerbs* and *Gottlieb*, upheld a ratification defense only where the awards to the directors under a plan were specific in amount and value. In *In re 3COM Corp. Shareholders Litigation*,[30] however, the Court of Chancery introduced a new element to the analysis, holding that stockholder approval of a plan contemplating director awards based on specific caps and with other determining factors was sufficient to give rise to a defense of ratification of awards made within the limits.

By contrast, in *Sample v. Morgan*, the Court of Chancery, without addressing *3COM*, declined to recognize a defense of ratification in circumstances where the two non-employee directors on the compensation committee awarded all 200,000 shares available for issuance under a stockholder-approved plan to the three employee directors.[31] The *Sample* Court stated that "[t]he Delaware doctrine of [stockholder] ratification does not embrace a 'blank check' theory" and that the stockholders' grant of authority to the directors to issue discretionary awards was not designed to supplant the board's fiduciary duties in making decisions to grant such awards.

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The Court of Chancery's opinion in *Seinfeld v. Slager* attempted to reconcile the various strands. In that case, the *Seinfeld* Court held that the stockholders' approval of a broad based omnibus plan with a single generic limit on awards was not sufficient to invoke the defense of ratification.[32] The *Seinfeld* Court articulated the notion that directors could invoke a ratification defense for self-interested compensation decisions on the basis that the stockholders had approved a plan containing meaningful limits on awards.[33]

Following its review of the precedent of the Court of Chancery, the Supreme Court stated that the

opinion in *3COM* (and its progeny) essentially had led to the difficulties giving rise to the present case.[34] To this end, the Supreme Court stated that the defense of ratification to preclude judicial review of director self-compensation decisions is not problematic in circumstances where the plan contains "self-executing" grants (in the sense that the directors are not entitled to exercise discretion in making the award and the awards are made in the amounts and on the terms provided in the plan) or in situations where the stockholders have approved the specific awards that were made. But the Supreme Court indicated that *3COM* precipitated an attempt by the Court of Chancery to harmonize the area of the law through the introduction of the "meaningful limits" test.[35]

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The Supreme Court then effectively rejected the meaningful limits test, at least as articulated in *Seinfeld* and applied in the lower court's *Investor Bancorp* opinion, stating that where directors are able to exercise discretion under a stockholder-approved equity incentive plan, the defense of ratification would not operate to foreclose review of the grants where the plaintiff has properly alleged a breach of fiduciary duty claim.[36] The Supreme Court concluded the directors' exercise of authority granted under a stockholder-approved plan must be consistent with their fiduciary duties.

In the present case, the plaintiffs had alleged that the directors granted themselves excessive awards, asserting, among other things, that the Board had used the grants to reward past-performance relating to the Company's mutual-to-stock conversion (rather than providing incentives to reward future performance as was disclosed to stockholders), and that the directors' compensation was materially higher than directors in the Company's peer group (as well as director pay at Wall Street firms). For those and other reasons, the Supreme Court found that the plaintiffs, at the pleading stage, had alleged facts leading to a reasonable inference that the directors breached their fiduciary duties in setting their own compensation.

Key Takeaways

The Supreme Court's opinion provides significant guidance to corporations and practitioners in designing equity incentive plans. The opinion indicates that corporations and practitioners should consider adopting plans (or amending their existing plans) to provide for self-executing grants for non-executive directors, as such awards will be insulated effectively from judicial review. Nevertheless, corporations should recognize that including self-executing awards in their plans may provide proxy advisory firms and other constituents with undue influence over director compensation. That is, if a proxy advisory firm recommends against a plan providing only a single compensation amount for directors, and the stockholders follow that recommendation, the directors would be hard-pressed to compensate themselves at that level, even if they believe in good faith that providing such compensation is required to attract and retain qualified directors. Thus, many corporations may find it advantageous to retain in their plans some measure of discretionary authority for the directors in fixing their own compensation, even if doing so means that the board, in making such compensation decisions, will not be entitled to the presumption of the business judgment rule.

Of course, if the plan provides discretionary authority, the directors' subsequent compensation decisions under that plan will be subject to judicial review, with the court examining the price and process components of any decision. Thus, if the corporation is inclined to retain a measure of discretionary authority, the board should consider engaging compensation consultants and

counsel to assist in crafting a plan that promotes the corporation's objectives, including by allowing the corporation to attract and retain qualified directors and helping to align their interests with those of the stockholders generally. In drafting new plans or amending existing plans, the directors, in consultation with their advisors, should consider establishing ranges and terms based on comparable data and other objective criteria. Moreover, the directors should consider making subsequent decisions under the plan with the assistance of compensation consultants and should ensure that the basis for their decisions is carefully documented. Employing procedural measures should assist in defending any challenge to the directors' exercise of discretion under the plan.

Notes

1. 2017 WL 6374741, — A.3d —, (Del. Dec. 13, 2017).
2. *In re Investors Bancorp, Inc. S'holder Litig.*, WL 1277672, at *8, n.33 (Del. Ch. Apr. 5, 2017).
3. *Id.* at *1. *See generally In re 3COM Shareholders Litigation*, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999). *Calma v. Templeton*, 2015 WL 2265535 (Del. Ch. Apr. 30, 2015).
4. *Investors Bancorp*, 2017 WL 6374741, at *1.
5. *Id.* at *1.
6. *Id.* at *2.
7. *Id.*
8. *Id.* at *3.
9. *Id.*
10. *Id.*
11. *Id.* at *4.
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.* at *4 - 5.
16. *Id.*
17. *Id.* at *5.
18. *Id.*
19. *Id.*
20. *Id.* at *6. Section 141(h) of the Delaware General Corporation Law provides: "Unless otherwise restricted by the certificate of incorporation or bylaws, the board of directors shall have the authority to fix the compensation of directors." 8 *Del. C.* § 141(h).
21. *Investors Bancorp*, 2017 WL 6374741, at *6.
22. 90 A.2d 652 (Del. 1952).
23. 90 A.2d 660, 663 (Del. 1952).
24. *Investors Bancorp*, 2017 WL 6374741, at *8.
25. *Kerbs*, 90 A.2d at 655.
26. *Gottlieb v. Heyden Chemical Corp.*, 91 A.2d 57, at 58 (Del. 1952).
27. *Investors Bancorp*, 2017 WL 6374741, at *7 (quoting *Gottlieb*, 91 A.2d at 58).
28. 1995 WL 441999 (Del. Ch. July 19, 1995).
29. 699 A.2d 327, at 338 (Del. Ch. 1997).
30. *3COM* , 1999 WL 1009210, at *1.
31. *Sample v. Morgan*, 914 A.2d 647 (Del. Ch. 2007).
32. 2012 WL 2501105, at *11–12 (Del. Ch. June 29, 2012).
33. *Id.* at *12.
34. *Investors Bancorp*, 2017 WL 6374741, at *10.
35. *Id.*
36. *Id.* at *11.