



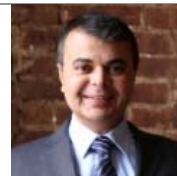
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Delaware Supreme Court Limits Ratification Defense for Director Compensation Awards



By S. Michael Sirkin and Nick Mozal January 3, 2018

Comment

On December 13, the Delaware Supreme Court^[1] reversed the Court of Chancery's decision in *In re Investors Bancorp, Inc. Stockholder Litigation*,^[2] and held that entire fairness will apply to any board's decision to award director compensation unless the award is either (1) specifically approved after the fact "by fully informed, uncoerced, and disinterested stockholders," or (2) effectively pre-approved, in the form of a "self-executing" plan that leaves no room for discretion with respect to specific awards. This marks a change in Delaware law, and eliminates the discretion that boards previously could exercise safely under stockholder-approved compensation plans with "meaningful limits" for director compensation. Now, if directors have any amount of discretion in setting their own compensation, they risk invoking the entire fairness standard, meaning they will face an uphill battle in prevailing on dispositive pre-trial motions, and will bear the burden of proving their compensation is fair.

Background Law

Section 141(h) of the Delaware General Corporation Law grants directors statutory authority to award themselves compensation. For at least six decades, Delaware Courts have recognized that a board's exercise of that statutory authority—directors deciding on the corporation's behalf how much to pay themselves—is a self-dealing transaction, and have applied the entire fairness standard as a result.^[3] Those early decisions also recognized, however, that if the challenged awards were specifically approved by stockholders, then the business judgment rule would apply instead.^[4]

In 1999, the Delaware Court of Chancery expanded the discretion afforded to directors with respect to their own compensation by upholding a ratification defense in the context of director compensation decisions made pursuant to a stockholder-approved plan with "specific ceilings" on awards to each director.^[5] In recent years, therefore, directors could safely exercise discretion within the limits of a stockholder-approved plan without submitting each award for stockholder approval.

Background of the Investors Bancorp Decision

In 2014, the outside directors of Investors Bancorp, Inc. (the "Company") received an average of \$133,340 in compensation. At the end of 2014, the Company's compensation committee recommended an increase, but only in certain per-meeting fees. The compensation committee did not recommend additional equity awards.

In March 2015, the board proposed a new equity incentive plan. The plan provided ceilings on the number of shares that could be awarded to any individual, and on the number of shares that could be awarded to outside directors in the aggregate, but otherwise did not specify awards to any individual recipients. The Company's proxy statement asked stockholders to approve the plan, and noted that "[t]he number, types and terms of awards to be made pursuant to the [plan] are subject to the discretion of the Committee and have not been determined at this time."

The Company's stockholders overwhelmingly approved the plan, and the board approved equity awards of over \$2 million to each outside director. Stockholder plaintiffs challenged the new awards as excessive, despite being compliant within the limits of the plan, alleging that awards at peer companies averaged roughly \$175,000.

On a motion to dismiss, the Court of Chancery^[6] reviewed the decisional law of the applicability of a ratification defense to director compensation decisions, and contrasted "between stockholder approval of a plan that features board parameters and 'generic' limits applicable to all plan beneficiaries on

the one hand and, on the other hand, a plan that sets ‘specific limits on the compensation of the particular class of beneficiaries in question.’”^[7] The court concluded the Company’s plan “contained meaningful, specific limits on awards to all director beneficiaries,”^[8] and applied the business judgment rule because the awards were “within the bounds of th[o]se limits.”^[9]

The Supreme Court Decision

The Supreme Court synthesized previous decisions applying ratification into three groups. The first two—where stockholders approve specific awards or where a plan is self-executing and directors had no discretion in making subsequent awards—“present[ed] no real problems” because “[w]hen stockholders know precisely what they are approving, ratification will generally apply.”^[10]

But in the third category, the Supreme Court concluded that “when 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.”^[11] The court emphasized that “[w]hen stockholders approve the general parameters of an equity compensation plan and allow directors to exercise their ‘broad legal authority’ under the plan, they do so ‘precisely because they know that authority must be exercised consistently with equitable principles of fiduciary duty.’”^[12] As a result, where “a stockholder properly alleges that the directors breached their fiduciary duties when exercising their discretion after stockholders approve the general parameters of an equity incentive plan, the directors should have to demonstrate that their self-interested actions were entirely fair to the company.”^[13]

Key Takeaways and Conclusion

Director compensation decisions remain inherently self-interested, making the availability of a ratification defense critical to mitigating the risk of stockholder litigation. In *Investors Bancorp*, the Supreme Court established that ratification will only be available if stockholders specifically approve the challenged awards, whether in advance, in the form of a “self-executing plan,” or by voting after the fact to approve specific grants to specific beneficiaries. A director compensation scheme that leaves any discretion for directors is more likely to attract stockholder challenges, and directors should understand the litigation risks associated with awards under such schemes.

ENDNOTES

[1] *In re Inv’rs Bancorp, Inc. Stockholder Litig.*, — A.3d —, 2017 WL 6374741, at *1 (Del. Dec. 13, 2017) (hereinafter “Supreme Court Decision”).

[2] *In re Inv’rs Bancorp, Inc., Stockholder Litig.*, 2017 WL 1277672, at *6 (Del. Ch. Apr. 5, 2017) (hereinafter “Chancery Decision”).

[3] See, e.g., *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660, 663 (Del. 1952).

[4] See, e.g., *Kaufman v. Shoenberg*, 91 A.2d 786 (Del. Ch. 1952).

[5] *In re 3COM S’holders Litig.*, 1999 WL 1009210, at *3 (Del. Ch. Oct. 25, 1999).

[6] The Court of Chancery’s decision has already been discussed at length here: <http://clsbluesky.law.columbia.edu/2017/04/21/paul-weiss-discusses-delaware-court-of-chancery-decision-on-equity-incentive-plan-ratification/>.

[7] *Id.* (quoting *Calma on Behalf of Citrix Sys., Inc. v. Templeton*, 114 A.3d 563, 587 (Del. Ch. 2015)).

[8] *Id.* at *8.

[9] *Id.*

[10] Supreme Court Decision at *10.

[11] *Id.* at *11.

[12] *Id.* (quoting *Sample v. Morgan*, 914 A.2d 647 (Del. Ch. 2007)).

[13] *Id.* at *11.

This post comes to us from S. Michael Sirkin and Nick Mozal, attorneys at the Delaware firm of Ross Aronstam & Moritz LLP.

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