

Court Reevaluates Stockholder Ratification of Director Compensation for First Time in Decades

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In a Dec. 19, 2017, decision, *In re Investors Bancorp Stockholder Litigation*, No. 169, 2017 (Del. Dec. 19, 2017), the Delaware Supreme Court considered the limits of a stockholder ratification defense when directors make equity awards to themselves under an equity incentive plan or “EIP.” Justice Collins J. Seitz Jr. wrote for a unanimous court that when “stockholders did not ratify the specific awards the directors made under the EIP,” and instead ratified only “general parameters” for director compensation, the proper standard for review of those awards is entire fairness. As the Supreme Court itself acknowledged, this was the first time it addressed ratification of director self-compensation decisions since its 1952 decision in *Gottlieb v. Heyden Chemical*, 90 A.2d 660 (Del. 1952).

In 2015, the board of directors of Investors Bancorp, Inc. proposed an EIP, pursuant to which the company reserved shares of common stock for various types of stock awards to the company’s officers, employees, and directors. In particular, the EIP provided that nonemployee directors could, in the aggregate, receive a maximum of “30 percent of all option or restricted stock shares



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available for awards, all of which may be granted in any calendar year.” However, the EIP provided that the exact terms of the awards would not be determined until after stockholders approved the EIP, and would be subject to the discretion of the board’s compensation committee. The EIP was approved by 96.25 percent of voting shares at the company’s 2015 annual meeting. Soon thereafter, the compensation committee approved equity awards to all board members, with the awards to nonemployee directors totaling over \$21.5 million and averaging over \$2 million per

director, which allegedly far surpassed the \$198,000 median pay for non-employee directors at similarly sized companies.

After the awards were publicly disclosed, several stockholders filed suit in the Delaware Court of Chancery alleging that the directors breached their fiduciary duty by awarding themselves excessive compensation. On April 5, 2017, the Court of Chancery granted defendants’ motion to dismiss the complaint against the non-employee directors. In so doing, the court held that the affirmative defense of stockholder ratification

was available—meaning that the court would apply a deferential business judgment standard of review, rather than requiring the directors to prove that the awards were entirely fair to the corporation—because the company’s stockholders had approved an EIP that contained “meaningful, specific limits on awards to all director beneficiaries,” and was not merely a “broad-based plan ... that contained a generic limit” on director awards.

On Dec. 19, 2017, the Supreme Court unanimously reversed the Chancery Court’s decision. Following the Supreme Court’s 1952 decision in *Gottlieb*, directors have been able to successfully assert a ratification defense to claims arising from directors’ self-compensation decisions when the stockholders were fully informed and approved specific director awards. However, the defense was unavailable when stockholders had merely approved general stock compensation plans, with the specific awards not yet determined. This dichotomy served an important purpose: balancing the “competing concerns” of the “utility of the [stockholder] ratification defense” in providing directors confidence and security when acting pursuant to stockholder approval, and “the need for judicial scrutiny of certain self-interested discretionary acts by directors.” However, the Chancery Court’s decisions since *Gottlieb* broadened the scope of the ratification defense. For example, the Chancery Court held in *In re 3COM Shareholders Litigation*, C.A. No. 16721, 1999 WL

1009210 (Del. Ch. Oct. 25, 1999), and *Criden v. Steinberg*, 2000 WL 354390 (Del. Ch. Mar. 23, 2000), that the ratification defense was available where stockholder-approved compensation plans set “specific ceilings” for awards but still permitted directors to exercise discretion in determining the precise award in certain circumstances. The Court of Chancery further elaborated on this principle in *Seinfeld v. Slager*, 2012 WL 2501105 (Del. Ch. June 29, 2012), where it held that plans must have some “meaningful limit” for ratification to potentially apply.

In *Investors Bancorp*, the Supreme Court rejected the nuanced “meaningful limit” approach charted by the Chancery Court, holding that “when 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.” The court noted that where directors have discretion to determine their own awards pursuant to such “general parameters,” those awards “are self-interested decisions not approved by the stockholders.” Accordingly, if directors subsequently “acted inequitably when making the awards, their inequitable action does not become permissible simply because it is legally possible under the general authority granted by the stockholders.”

Applying those principles, the court found that a stockholder

ratification defense was unavailable to the directors of Investor Bancorp. While the Court of Chancery found that the EIP had sufficiently “meaningful” upper limits to qualify under the standard of *In re 3COM*, the Supreme Court rejected that approach, finding dispositive the fact that the “number, types and terms of the awards to be made pursuant to the EIP are subject to the discretion of the [directors]” and were not determined “until subsequent to stockholder approval.” In short, “because the stockholders did not ratify the specific awards the directors made under the EIP, the directors must demonstrate the fairness of the awards to the company.”

Investors Bancorp provides important guidance from the Delaware Supreme Court for the first times in decades on the application of a stockholder ratification defense to directors’ granting of self-interest awards under equity compensation plans. We expect these plans will continue to come under scrutiny from Delaware courts in the future.

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