

Securities Litigation Alert

December 22, 2017

Key Points

- Directors were not entitled to stockholder ratification defense where stockholders only approved the general parameters of director and employee bonuses
- This marks the first time in nearly 60 years that Delaware's highest court considered the law regarding ratification of director self-compensation
- Corporate directors are now on notice to provide complete details if they intend to seek stockholder approval of self-dealing actions



Delaware Supreme Court Reins in Stockholder Ratification of Director Compensation

Details matter when corporate directors seek approval for their own compensation packages, according to the Delaware Supreme Court. On December 13, 2017, Delaware's highest court issued its decision in *In re Investors Bancorp, Inc. Stockholder Litigation*, Case No. 169, 2107, providing the Delaware Supreme Court's first refinement of Delaware law regarding ratification of director self-compensation in nearly 60 years. The decision overturned the Chancery's Court's dismissal of plaintiffs' action alleging that the defendant directors unduly enriched themselves at the stockholders' expense.

Background

Plaintiffs, stockholders in Investors Bancorp, brought the derivative action against the company's directors after discovering that the directors awarded themselves \$51.5 million of a \$116 million employee equity incentive program approved for the benefit of the company's directors, as well as its nearly 1,800 employees. Because a board's approval of its own compensation is an inherently self-dealing transaction, such approval is closely scrutinized under Delaware law and generally evaluated under the strict "entire fairness" standard of review. However, the defendant directors argued that the more lenient "business judgment" standard was appropriate because the stockholders ratified the \$116 million incentive program after being informed of the potential amounts that could be awarded to directors.

The parties did not dispute that the proxy describing the \$116 million incentive program accurately explained the general parameters of awards that could be made to employees and non-employee directors. Nor was there any dispute that the \$51.5 million awarded to the directors fell within the limits described in the proxy. Instead, plaintiffs chiefly argued that they were misled concerning the allocation of the \$116 million, which according to the proxy was intended to "attract, motivate and retain highly qualified

officers, employees and directors” with specific awards that had yet to be determined. This, according to plaintiffs, was at odds with the directors awarding themselves nearly half of the total amount a mere two weeks after stockholder approval of the plan. Plaintiffs relatedly argued that the compensation parameters described in the proxy were too vague for defendant directors to claim stockholder ratification of their eventual awards.

Dismissal in the Chancery Court

The Delaware Chancery Court rejected plaintiffs’ arguments and granted dismissal in favor of the defendant directors in April 2017. In the memorandum opinion, Vice Chancellor Slight ruled that the proxy adequately described the potential compensation to the directors and that Delaware law did not support plaintiffs’ arguments concerning material omissions in the proxy. The Chancery Court determined that the case did not present a situation where the directors effectively requested a “blank check” from shareholders. Accordingly, because the stockholder vote was fully informed, the director awards were evaluated under a business-judgment standard of review, which, under Delaware law, defaults to waste, which plaintiffs did not plead.

The Chancery Court further ruled that plaintiffs failed to adequately plead demand futility as to the equity awards granted to two employee directors who received significantly higher amounts than the other nonemployee directors. Plaintiffs had argued that, even though their claims as to the employee directors did not directly implicate the board generally, a majority of the board still could not fairly consider the claims because the awards issued to the rest of the board were part of the same transaction. The Chancery Court rejected application of the so-called “single transaction” or “quid pro quo” doctrine because the nonemployee directors received nothing in exchange for their approval of the executive awards.

Reversal in the Delaware Supreme Court

On appeal, the Delaware Supreme Court reversed the Chancery Court decision on both grounds. Considering the ratification of director self-compensation for the first time since 1960, the Delaware Supreme Court held that, “when stockholders have approved an equity incentive plan that gives the directors discretion to grant themselves awards within general parameters, and a stockholder properly alleges that the directors inequitably exercised that discretion, then the ratification defense is unavailable to dismiss the suit.” This, according to the Delaware Supreme Court, is in contrast to instances where the directors submit, and fully informed stockholders ratify, specific compensation plans that do not leave later details to the discretion of the directors.

Because the Investors Bancorp equity incentive plan was submitted to stockholders outlining general parameters only, the Delaware Supreme Court considered whether the directors inequitably exercised their discretion in awarding themselves nearly half of the total amount approved. The Delaware Supreme Court determined that plaintiffs adequately pleaded that the directors breached their fiduciary duties in making unfair and excessive discretionary awards to themselves, particularly in light of the allegations that the awards far exceeded not only director awards at the company for the prior year, but also the director pay at **every** Wall Street firm. Accordingly, the Delaware Supreme Court held that the stockholder

vote was ineffective to ratify the director compensation, thus requiring defendants to demonstrate the fairness of the awards to the company.

Turning to the question of whether demand on the board was futile as to the employee director awards, the Delaware Supreme Court rejected the Chancery Court's narrow view of the issue through the lens of a "single transaction" or "quid pro quo" theory. Instead, the Delaware Supreme Court broadly examined whether the directors could be considered disinterested and independent under the law, concluding that "[i]t is implausible to us that the non-employee directors could independently consider a demand when to do so would require those directors to call into question the grants they made to themselves."

The Delaware Supreme Court's decision in *In re Investors Bancorp* provides important new guidance regarding application of stockholder ratification of director self-compensation. More generally, the decision suggests that Delaware corporate directors would be wise to be as specific as possible when seeking stockholder ratification of any self-dealing action.

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