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Delaware Supreme Court Holds Ratification Defense Inapplicable to Certain Discretionary Incentive Plan Awards

Recently in *In re Investors Bancorp, Inc. Stockholder Litigation*, the Delaware Supreme Court held that stockholder ratification of an equity incentive plan that affords directors discretion cannot be used to foreclose the Court of Chancery from reviewing further discretionary actions by the directors when there is a properly alleged breach of fiduciary duty claim challenging those actions. In so holding, the Supreme Court reversed the Court of Chancery's dismissal of fiduciary duty claims challenging discretionary awards that the directors of Investors Bancorp had made to themselves in accordance with the terms of an equity incentive plan that had been approved by stockholders. Under the Supreme Court's holding, the stockholder vote did not serve to ratify the directors' awards to themselves, and the board must therefore show the fairness of these awards because of the unavailability of the deferential business judgment rule.

Background

In 2015, the board of Investors Bancorp adopted an equity incentive plan that contemplated various specified forms of stock and option grants to be awarded to the company's officers, employees, non-employee directors and service providers. The plan imposed several limitations, including on the number of shares that could be issued pursuant to the exercise of stock options and restricted stock awards and as restricted stock units and performance awards. There were separate limits of awards for employee and non-employee directors. The board sought and received overwhelming stockholder approval of the plan. Thereafter, all 12 directors awarded themselves restricted stock and stock options under the plan with an aggregate grant date value of approximately $51.65 million. Following announcements of these awards, the plaintiff stockholders brought a derivative action alleging that the compensation awards were excessive and unfair to the corporation. According to the plaintiffs, these awards "eclips[ed] director pay at every Wall Street firm," significantly exceeded director pay in the prior year and were 23 times more than the median award granted to non-employee directors at peer companies in similar contexts.

Relying on precedent (specifically *In re 3COM Corp. Shareholders Litigation* and *Calma on Behalf of Citrix Systems, Inc.* v. *Templeton*), the Court of Chancery dismissed the complaint against the non-employee directors in part because the equity incentive plan contained "meaningful, specific limits on awards to all director beneficiaries," rather than "generic" limits covering director and non-director beneficiaries. Therefore, the stockholder vote approving adoption of the plan served to ratify the specific equity awards to the directors made under it. For more on the Court of Chancery's decision, click here.

Delaware Supreme Court Opinion

On appeal, the Delaware Supreme Court, in an opinion by Justice Seitz, reversed and remanded the Court of Chancery's decision. Key holdings from the Supreme Court's opinion include the following:

- *Stockholder ratification is not a defense to claims challenging discretionary director awards made after stockholder approval of an equity incentive plan.* The Delaware Supreme Court identified three situations in which such a defense has been recognized by Delaware courts: (i) when stockholders approve specific director awards; (ii) when the plan was "self-executing" (i.e., the directors had no discretion when making the awards); and (iii) when directors exercised discretion and determined the amounts and terms of the awards after stockholder approval. A ratification defense in the first two scenarios, according to the Supreme Court, presents "no real problems" because stockholders know precisely what they are approving. With respect to the third scenario, however, the Supreme Court concluded that a ratification defense should not be available. Rejecting the Court of Chancery's attempt to distinguish between plans with "meaningful limits" versus generic limits, the Supreme Court held that no discretionary action should be insulated from review by the Court of Chancery under a ratification defense when a breach of fiduciary duty claim has been properly alleged. Awards under such a plan are treated as other self-interested actions by directors, who must demonstrate that the awards are entirely fair to the company given that the deferential business judgment standard does not apply.

- *The Investors Bancorp equity incentive plan is a discretionary plan not subject to the ratification defense, and therefore the directors must demonstrate the fairness of the awards to the company.* Plaintiffs alleged the directors breached their fiduciary duties in connection with the awards under the equity incentive plan, including by (i) granting awards to reward past services instead of for future performance as was disclosed to stockholders, and (ii) making rewards that were "inordinately higher" than peer companies' awards. According to the Supreme Court, the plaintiffs alleged facts to support a pleading stage reasonable inference that the directors breached their fiduciary duties in making the awards after stockholder approval of the plan, and because the stockholders did not approve the specific awards, the directors must demonstrate the fairness of awards to the company.

Observations

Based on this decision, boards adopting incentive plans allowing for discretion in making awards to themselves should understand the limits of the stockholder approval of such plans and recognize that their grant decisions will likely continue to be scrutinized under the exacting standard of entire fairness, particularly where the awards are arguably not in line with prior company awards or industry practice.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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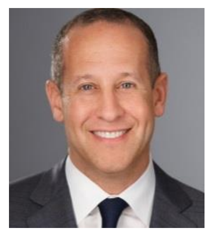

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