Corporate Litigation:

Stockholder Challenges to Executive Compensation

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April 11, 2018

Investors, proxy advisory services and corporate governance watchdogs closely monitor executive compensation, and express their views on executive pay in diverse fora, ranging from advisory Say on Pay votes required under the Dodd-Frank Act to a CEO Salary Watchdog Facebook page. In the absence of stockholder approval, if a stockholder adequately alleges that directors breached their fiduciary duties by awarding themselves equity pursuant to an incentive plan, the directors must prove that the awards are entirely fair to the corporation. In litigation challenging compensation awarded by the board under an equity incentive plan that has been approved by a majority of informed and disinterested stockholders, however, the affirmative defense of stockholder ratification becomes relevant. Otherwise self-interested director compensation awards made within the confines of a fixed plan approved by fully informed stockholders may be subject to the deferential business judgment rule, not the entire fairness standard. The Delaware Supreme Court recently clarified the limits of the stockholder ratification defense in litigation challenging director compensation awarded under the parameters of a stockholder-approved compensation plan. In *In re Inv'rs Bancorp Stockholder Litig.*, 177 A.3d 1208 (Del. 2017), the court recognized a business-judgment safe harbor for directors where the equity awards approved by stockholders are sufficiently specific as to amounts and terms. But when stockholders have approved an equity incentive plan that gives directors discretion to grant themselves awards within general parameters, and a stockholder adequately alleges that the directors inequitably exercised that discretion, a ratification defense is unavailable and the directors must prove the fairness of the awards to the corporation.

Review of Executive Compensation

Unless restricted by the certificate of incorporation or bylaws, §141(h) of the Delaware General Corporation Law authorizes the board of directors to fix compensation for directors and officers of the corporation. When it comes to decisions on executive compensation or severance payments, the business judgment rule affords directors great deference, recognizing that "[i]t is the essence of business judgment for a board to determine if a particular individual warrants large amounts of money, whether in the form of current salary or severance provisions." *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000) (internal quotation omitted). At bottom, the personal services of executives and directors are assets bought and sold in a negotiated market. Courts ordinarily will evaluate compensation decisions under the standards applicable to corporate waste, which provide "a residual protection for stockholders that polices the outer boundaries of the broad field of

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discretion afforded directors by the business judgment rule." *Sample v. Morgan*, 914 A.2d 647, 669 (Del. Ch. 2007).

Director decisions regarding how to compensate themselves, including with equity awards, obviously involve self-interest. With limited exception, in order to safeguard against potential dilution resulting from equity-based awards, the NYSE's Listed Company Manual requires that stockholders be given the opportunity to vote on all equity compensation plans and material revisions thereto. Delaware law generally has been understood to extend business judgment deference to directors who administer a shareholder-approved stock incentive plan within its stated terms, including when directors award themselves equity compensation under the plan. *In re 3COM*, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999). Self-interested directorial compensation decisions made without independent protections such as a stockholder approved plan, like other interested transactions, are subject to entire fairness review. For years, however, courts would nevertheless apply the more deferential business judgment rule to directors' self-compensation decisions if such decisions were made under a plan with meaningful limits approved by the corporation's stockholders. This is known as a stockholder ratification defense. A bright line between a plan with meaningful limits and one which gives discretion to directors has proved elusive.

'Investors Bancorp'

In 2014, annual compensation for the company's non-employee directors averaged $133,340 in cash, without any equity awards. At the 2015 annual meeting, a majority of the Company's disinterested stockholders voted to approve a proposed Equity Incentive Plan (Plan) for director, officer and employee compensation. The stated purpose of the Plan was to incentivize the Company's officers, employees and directors to deliver strong corporate performance, and to attract and retain quality individuals. The Plan imposed limits on (1) the number of shares that could be issued as stock options or as restricted stock awards, restricted stock units or performance shares, and (2) the number of shares that could be awarded to employees and directors. The Plan reserved up to 30 percent of equity awards for the board's non-employee directors. The company proxy disclosed that the "number, types and terms of awards to be made pursuant to" the Plan were subject to the discretion of the Compensation Committee (and subsequent board approval) and these matters would not be determined until after stockholder approval of the Plan. After the plan was approved by stockholders, the Compensation Committee (composed of seven of the 10 non-employee directors) then held four meetings, received input from consultants, and approved awards of restricted stock and stock options to all board members. The non-employee director awards totaled $21,594,000 and averaged $2,159,400, a sixteen-fold increase over the previous year.

Stockholder plaintiffs sued derivatively in the Court of Chancery, alleging breaches of fiduciary duty by the directors for awarding themselves excessive compensation. Plaintiffs alleged, among other things, that although the proxy seeking stockholder approval was reasonably interpreted as describing the Plan as forward-looking, i.e., rewarding Company employees for future performance, not past services, the compensation was in fact "both backward-looking (i.e., a reward for past service rather than to incentivize future performance) and significantly higher than comparable, or even much larger non-comparable, companies' director compensation." The Court of Chancery dismissed the complaint against the non-employee directors, concluding that the Plan contained "meaningful, specific limits on awards to all director beneficiaries" and therefore subject to review under the deferential business judgment rule. The court also dismissed the claims as to the executive directors for failure to make a pre-suit demand on the board.

The Delaware Supreme Court reversed, ruling that the discretion given to directors in the Plan to approve specific amount and terms of equity awards precluded the stockholder ratification defense. The equity awards therefore were self-interested compensation decisions subject to the entire fairness standard of review.

The court clarified that availability of the stockholder ratification defense depends on the specificity of the acts submitted to the stockholders for approval. Ratification of self-interested compensation awards now is available in only two circumstances: (1) when stockholders approve specific director compensation awards, and (2) when the plan is self-executing, "meaning plans that make awards over time based on fixed criteria, with the specific amounts and terms approved by the stockholders." In both, uncertainty around what stockholders actually approve effectively is eliminated. The Plan in *Investors Bancorp* did not fit either profile; stockholders there "approved an equity incentive plan that gives the directors discretion to grant themselves awards within general parameters." In that scenario, "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." The court reasoned that because the actual compensation awards are self-interested decisions not approved by the stockholders, it is reasonable and equitable to ensure a second step review when a stockholder plausibly alleges a fiduciary breach. *Inv'rs Bancorp*, 177 A.3d at 1222-23.

Applying this standard at the motion to dismiss stage, the court concluded that plaintiff had adequately alleged that the challenged awards were excessive. Significantly, plaintiffs alleged a disclosure problem, contending that the stockholders were told the Plan would reward future performance, "but the Board instead used the ... awards to reward past efforts ... which the directors had already accounted for in determining their 2015 compensation packages." Moreover, plaintiffs asserted that "the rewards were inordinately higher than peer companies'."

Conclusion

Investors Bancorp may fuel a trend of stockholder challenges to director compensation decisions made pursuant to stockholder-approved plans that give directors meaningful discretion on self-compensation. An essential feature of a compensation plan that is ratifiable by stockholders is that the plan imposes specific limits on director compensation as to amounts and terms, i.e., stockholders know with reasonable precision exactly what they approve.

Two months after its *Investors Bancorp* decision, the Delaware Supreme Court reversed a Court of Chancery decision dismissing a complaint challenging a two-step merger, holding that shareholders' acceptance of the front-end tender offer was not fully informed where the reasons for the Chairman's decision to abstain from the board vote to recommend the transaction were not disclosed. *Appel v. Berkman*, 2018 WL 947893 (Del. Feb. 20, 2018). "Precisely because Delaware law gives important effect to an informed stockholder decision, Delaware law also requires that the disclosures the board makes to stockholders contain the material facts... ." What unites these decisions is the Delaware Supreme Court's emphasis on the importance of candid disclosure of all facts material to any decision stockholders are asked to make. Boards and their advisors preparing proxy statements seeking stockholder approval must exercise care to ensure disclosures cannot reasonably be challenged as misleadingly incomplete, as stockholder plaintiffs will likely cite these decisions as requiring scrutiny of proxy disclosures.

Striking a workable balance between reducing litigation risk by narrowing plan-authorized director discretion over equity awards, and ensuring the board has flexibility to respond to evolving internal and external conditions affecting director compensation requires careful consideration, and *Investors Bancorp* provides good reason for boards and their advisers to review director equity compensation plans and reconsider how those plans are disclosed in annual proxy statements.