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Top 5 Things Shareholder Activists Need to Know

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Editor's note: Steve Wolosky, Andrew Freedman, and Ron Berenblat are partners at Olshan Frome Wolosky LLP. This post is based on an Olshan publication by Mr. Wolosky, Mr. Freedman, and Mr. Berenblat. Related research from the Program on Corporate Governance includes Dancing With Activists by Lucian Bebchuk, Alon Brav, Wei Jang, and Thomas Keusch (discussed on the Forum here).

In re Investor Bancorp, Inc. Stockholder Litigation, issued by the Delaware Supreme Court on Dec. 13, 2017, may result in challenges to compensation awarded to directors pursuant to existing discretionary equity plans and is likely to affect the structure of future equity plans.

The Supreme Court, at the motion to dismiss stage, rejected the Court of Chancery's expansion of the application of the stockholder ratification defense to the granting of discretionary compensation to directors pursuant to equity plans that contain "meaningful limits" on awards. Reversing the decision below, the Supreme Court held that deferential business judgment review will *not* be available for (and the entire fairness standard of review will apply instead to) challenges to awards made under such equity plans if the plaintiff alleges facts that support an inference that the directors may have breached their fiduciary duties when determining the awards. The Supreme Court reasoned that when stockholders grant directors broad authority to use their discretion in making self-interested decisions, the stockholders do so knowing that the directors are subject to fiduciary standards in exercising that discretion; and that, therefore, there is a need for judicial oversight of the exercise of that discretion. The Supreme Court found in this case that the alleged facts sufficiently supported an inference of breach by the directors of their fiduciary duties for purposes of a motion to dismiss, as the awards granted appeared to have been "excessive" (based on their having been very significantly higher than the past compensation and the compensation at peer companies).

Pending further judicial development, it is uncertain how broadly the decision will be applied. In our view, notwithstanding the change in judicial course:

- ***With respect to an existing equity plan***, there should not be much risk of liability unless clearly excessive compensation was awarded under the plan (and/or there were other seriously problematic factors such as a flawed process or disclosure).
- ***With respect to future equity plans***, it should be possible to structure a plan to minimize the risk of liability by reducing the amount of (but not necessarily eliminating all) director discretion in determining awards under the plan. (See "Practice Points" below.)

Background

Investor Bancorp (which completed a bank mutual-company-to-stock conversion in 2014) accepted its Compensation Committee's recommendation and set 2015 compensation for its directors and officers at the same levels as in 2014. A few months thereafter, the board proposed a discretionary equity incentive plan (EIP) to provide "additional incentives." The EIP provided "meaningful limits" for awards—that is, a specified number of shares of common stock were reserved for restricted stock awards, restricted stock units, incentive stock options, and non-qualified stock options for the company's officers, employees, non-employee directors, and service providers. Sub-limits were provided for each category of award and each category of recipient. The non-employee directors were entitled to up to 30% of all of the reserved options and restricted stock shares, all of which could be granted in any calendar year. The number, types, and terms of the awards were subject to the board's discretion and would not be determined until after the stockholder approval of the EIP. Over 96% of the voting shares (which represented 79% of the shares outstanding) approved the EIP. Three days after the EIP was approved by the stockholders, the board held the first of four meetings during which, over the course of a month, they determined to issue to directors in 2015 (including the two executive directors, who were the CEO and COO) half of the available stock options and one-third of the available restricted shares, which had a total fair value of $51.7 million.

Discussion

The entire fairness standard of review will apply to challenges of discretionary awards under stockholder-approved equity compensation plans that include "meaningful limits"—if the facts pled indicate a possible breach of fiduciary duties by the directors. Due to directors' inherent self-interest when they determine discretionary equity awards for themselves, challenges to these awards have generally been subject to the entire fairness standard of review. However, when an equity plan approved by the stockholders provides for fixed awards, or when the specific awards made under a discretionary equity plan were ratified by the stockholders, then business judgment review has applied—based on ratification by the stockholders in a context where they "knew what they were approving." The Delaware Supreme Court long ago extended the stockholder ratification concept to discretionary equity plans that are "self-executing"—that is, where the awards are determined based on a formula, without further discretion by the directors.

Over the years, the Court of Chancery has extended the stockholder ratification concept further. While the Court of Chancery established that stockholder-approved discretionary equity plans with "generic" or "overall" limits on awards for directors and employees in the aggregate would *not* be entitled to business judgment review (*Calma/Citrix v. Templeton* (2016)), it has held that stockholder-approved equity plans with "meaningful limits" (*i.e.*, a specified cap applicable to the sub-group of non-employee directors) *would* be entitled to business judgment review (because stockholders approving the plan would know the contours of the awards that will be possible) (*3M Corp.* (1999), *Seinfeld v. Slager* (2012), and *Investor Bancorp* (Apr. 5, 2017)). In *Investor Bancorp*, the Supreme Court has now rejected that approach with respect to equity plans with "meaningful limits." Instead, in the event of a challenge to awards issued under such a plan, if the facts alleged indicate that it is reasonably conceivable that the directors breached their fiduciary duty when exercising their discretion in making the awards, then the directors will have to prove that the awards were entirely fair to the corporation.

The Supreme Court found that the alleged facts in this case as to the "excessive" nature of the awards sufficiently supported an inference (at the motion to dismiss stage) of a breach of fiduciary duties by the directors. The Court of Chancery had ruled that, although the awards were large in relation to the company's past compensation and peer group, they were within the equity plan's specified sub-limits and the plaintiffs had not established that they were so exorbitant as to constitute waste. The Supreme Court held, however, that the facts alleged indicated a possible breach of fiduciary duties, based on the awards having been "significantly" higher than the directors' past compensation and "inordinately" higher than directors' compensation at peer companies.

The Supreme Court's rationale for the change in course was a "need for continued equitable review of self-interested discretionary director self-compensation decisions." Justice Seitz wrote:

> When 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 that authority must be exercised consistently with equitable principles of fiduciary duty. The stockholders have granted the directors the legal authority to make awards. But, the directors' exercise of that authority must be done consistent with their fiduciary duties. Given that the actual awards are self-interested decisions not approved by the stockholders, if the directors 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…. [Stockholder approval of an equity incentive plan] cannot be reasonably interpreted as a license [for the directors] to do whatever they [wish], unconstrained by equity. Rather, it is best understood as a decision by the stockholders to give the directors broad legal authority and to rely upon the policing of equity to ensure that that authority would be utilized properly.

In our view, directors are unlikely to have liability for awards issued under discretionary plans unless the awards were excessive and/or there are other significantly problematic factors (such as a flawed process or disclosure). Pending further judicial development, in our view, liability is not likely unless there is a highly negative factual context, as was alleged in this case, where:

- The average compensation paid to the Investor Bancorp non-employee directors in 2014 was $133,340—which was in line with the average at peer companies; whereas the average paid in 2015 (including under the EIP) was over $2 million—while the average at peer companies was less than $176,000.
- The CEO's total compensation package was seven times higher than in 2014, and the $16.7 million value of the stock options and restricted stock he was awarded under the EIP was alleged to be 1,759% higher than the peer companies' average compensation for executive directors (and 3,683% higher than the median award that peer companies granted their CEOs after mutual-to-stock conversions).
- The COO's total compensation package was nine times higher than in 2014, and his $13.4 million award under the EIP was alleged to be 2,571% higher than the peer companies' average compensation for executive directors (and 5,384% higher than the

median that peer companies paid to their second-highest paid executives after conversions).

- The plaintiffs alleged that the disclosure relating to the approval of the EIP was flawed. The stockholders were told that "by approving the [EIP], stockholders will give the Company the flexibility it needs to attract, motivate and retain highly qualified officers, employees and directors by offering a competitive compensation plan that is linked to the performance of the Company's stock." The plaintiffs alleged that this statement was "forward-looking"—that is, that stockholders would have understood that awards under the EIP would incentivize *future performance* , not reward past services. After stockholders approved the EIP, however, the board approved the a ward of about half of the stock options and one-third of the restricted shares available to the directors, vesting over five years—which, the plaintiffs alleged, rewarded *past efforts* in connection with the company's mutual-to-stock conversion.
- The plaintiffs also alleged that the directors' process for determining the awards was flawed. For example, according to the plaintiffs, the expert who had advised the Compensation Committee had not considered an appropriate list of companies when determining peer company averages; and the CEO allegedly had proposed the awards for himself and the COO and they had attended the meetings at which their awards were approved although the company had disclosed that they had not attended meetings at which their compensation was determined.

Practice Points

- **With respect to future director compensation plans**, there is a clear safe harbor in (a) having stockholders approve the specific equity awards or (b) adopting a "self-executing" equity plan. Alternatively, a company could consider whether there is a place on the continuum between "self-executing" equity plans and equity plans with "meaningful limits" where the court, under *Investor Bancorp*, would view the directors as having had sufficiently little discretion, and the stockholders as having had sufficient knowledge as to what they were approving, that business judgment review would apply. For example, the following could be considered:
    - An equity plan that provides that the awards are essentially "self-executing," by being determined based on a formula without further discretion by the directors other than potentially providing plan administrators (generally the board or a committee of directors) with the ability to use negative discretion under certain circumstances;
    - An equity plan that provides specific limits for each individual director rather than for directors in the aggregate—as the stockholders would, in effect, be approving for each director a specific award, up to the maximum set for that director;
    - An equity plan that provides more restrictive "meaningful limits" (such as not only sub-limits for each group but limits for each year) and/or provides very specific guidelines for setting awards (such as the award having to be within a specified range of peer companies' average compensation and/or other quantitative parameters)—so that the degree of director discretion involved is minimized and stockholders are provided with more specificity as to what they are being asked to approve; or,
    - An equity plan that combines a specific award piece, a self-executing piece, and a discretionary piece, with the discretionary piece subject to specific caps or

other mechanisms that limit the discretion (such as, detailed parameters or, possibly, determination of the discretionary piece by an independent consultant or a designated director who will not receive discretionary awards).

- **With respect to existing discretionary director compensation equity plans,** boards should take particular care when approving the grant of equity awards—from the perspective both of substance (*i.e.* , the amounts of the awards) and process, with the objective of minimizing the risk of excessive compensation claims. A board may also consider amending its existing discretionary director compensation equity plans (a) to make them “self-executing” or (b) to conform to one of the formulations described below. A board may wish to seek stockholder ratification of awards already made if a favorable outcome would be expected.
- **Importance of the process, the disclosure and the record.** When determining awards under an equity plan, the directors should establish a record that documents what principles they applied to determine the awards, as well as how the awards compare to past compensation and peer companies’ compensation and the business rationale for any differences. The disclosure relating to the approval of an equity plan should be accurate (including whether the awards will reward past performance or incentivize future performance) and consistent with the purpose and material provisions of the equity plan. We note that, based on the facts alleged, the process and disclosure in *Investor Bancorp* suggested possible duplicity on the directors’ part in terms of the timing of the setting of the awards (immediately after stockholder approval of the equity plan), and not disclosing to stockholders that the awards would relate to the directors’ efforts in connection with the mutual-to-stock conversion that had just been completed and would be very large.