Limits of Stockholder Ratification Defense When Directors Make Equity Awards to Themselves

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In a stockholder litigation involving a bank defendant in December 2017, the Delaware Supreme Court considered the limits of the stockholder ratification defense when directors make equity awards to themselves under the general parameters of an equity incentive plan. 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." In our June 2015 summary, we discussed the Calma decision, in which the Court of Chancery distilled 60 years of case law regarding stockholder ratification down to two principles: (1) "valid stockholder ratification leads to waste being the doctrinal standard of review for a breach of fiduciary duty claim," and (2) "the affirmative defense of ratification is available only where a majority of informed, uncoerced, and disinterested stockholders vote in favor of a specific decision of the board of directors."

In the matter regarding a bank defendant, the equity incentive plan at issue was approved by the stockholders, but the plan left the directors with the discretion to allocate up to a certain percentage of all option or restricted stock shares available as awards to themselves. According to the proxy sent to the stockholders in this case, the number, types and terms of awards to be made pursuant to the plan at issue was subject to the discretion of the compensation committee and had not been determined at the time the board sought stockholder approval.

Here, the issue is whether the approval of the equity incentive plan had any "meaningful limits" on the awards directors could make to themselves. As the Court noted, if discretionary plans do not contain any meaningful limits, the awards, if challenged, are subject to an entire fairness standard of review. As ratification has evolved for stockholder-approved equity incentive plans, the courts have recognized the defense in three situations—when stockholders approved the specific director awards; when the plan was self-executing, meaning the directors had no discretion when making the awards; or when directors exercised discretion and determined the amounts and terms of the awards after stockholder approval. While the first two scenarios, according to the Court, present no real problems, the third scenario raises concern given the fact that the directors retain discretion to make awards.

As the Supreme Court noted, when stockholders approve an equity incentive plan that gives 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 and the directors will be required to prove the fairness of the awards to the corporation, because 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.

As further noted by the Court, 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. While a number of other cases reinforce this point, this case involving the bank defendant is important because it reaffirms the lesson that directors awarding shares to themselves under an equity incentive plan should seek stockholder approval or ratification as to specific awards, leaving little to no discretion to the directors themselves. Otherwise, the stockholder ratification defense may not be available, and directors must then demonstrate the entire fairness of the awards.