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PERSPECTIVE

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Guidance on grants of equity to directors

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In *In re Investors Bancorp, Inc. Stockholder Litigation*, the Delaware Court of Chancery provided guidance on grants of equity awards to directors. Specifically, the court held that the approval of Investors Bancorp's stockholders of an equity incentive plan with identified limits on the number of awards that could be granted to directors under the plan constituted a ratification of the awards granted to the directors. The stockholder ratification of the grants resulted in the court reviewing the grants for waste rather than for entire fairness.

Bancorp's board of directors adopted an equity incentive plan under which 30,881,296 shares of Bancorp's common stock were reserved for the exercise and settlement of restricted stock awards, restricted stock units, incentive stock options and non-qualified stock options granted to the company's officers, employees, non-employee directors and service providers.

Although the number, type and terms of awards granted under the equity incentive plan were subject to the discretion of Bancorp's compensation committee, the equity incentive plan contained the following series of limits:

• up to 17,747,455 shares could be issued upon exercise of stock options;

• up to 13,234,841 shares could be issued as restricted stock awards or performance shares or upon settlement of restricted stock units;

• up to 4,411,613 shares could be issued to any employee pursuant to the exercise of stock options;

• up to 3,308,710 shares could be issued to any employee as restricted stock or upon settlement of restricted stock units; and

• up to 30 percent of all shares of restricted stock and shares issuable upon exercise of stock options could be issued to non-employee directors.

Approximately three months after obtaining stockholder approval of the equity incentive plan, Bancorp's board of directors granted equity awards to Bancorp's directors with a fair value on the date of grant of approximately $51.5 million.

> *Bancorp* provides further guidance on the effect of stockholders' approval of an equity incentive plan that includes limits on the amount of equity granted to directors.

The plaintiffs commenced an action against Bancorp's directors alleging, among other things, that the awards granted to the directors were excessive and unfair to Bancorp.

The court dismissed the action for failure to plead a claim of breach of fiduciary duty against the directors because the stockholders' approval of the equity incentive plan was fully informed and the plaintiffs did not plead a claim of waste.

Unless the court determined that the stockholders' approval of the equity incentive plan ratified the equity award grants to the directors, the entire fairness standard of review would apply to the grants because the board of directors approved the equity award grants to its own members.

The court rejected the plaintiffs' arguments that (i) the equity incentive plan must contain "meaningful limits" on the amount of the equity awards that the board of directors could grant to its own members, and the defendants did not seek stockholder approval of the equity awards granted to themselves; and (ii) the stockholders did not disclose all material facts regarding the equity incentive plan when the stockholders approved that plan.

In an earlier case, *Calma on Behalf of Citrix Systems, Inc. v. Templeton*, the court decided that stockholder approval of an equity incentive plan that sets "specific limits" on the compensation of a particular class of beneficiaries under the plan will be deemed to be a ratification of any equity awards granted within the limits prescribed by that plan. As a result, the *Citrix* court found that the awards granted under an equity incentive plan had not been ratified because that plan, as approved by the stockholders, covered varied classes of beneficiaries and did not contain any limits on the grants to any class of beneficiaries.

The court in *Bancorp* did not find the fact that the equity incentive plan applied only to directors and fixed precisely the pay that directors could receive, as was the case in *In re 3COM Corp. Shareholders Litigation*, to be any different than an equity incentive plan applied to various beneficiaries with a specific limit set on the number of equity awards that could be granted to the directors. Moreover, Bancorp's equity incentive plan provided certain limits on the number of stock options, restricted stock and restricted stock units that could be granted in a calendar year to certain employees.

Bancorp provides further guidance on the effect of stockholders' approval of an equity incentive plan that includes limits on the amount of equity granted to directors. The board of directors of an early-stage company commonly approves an equity incentive plan that gives the board maximum flexibility with respect to granting awards and does not include any limits on the number of awards that the board may award directors. The strong push towards standardizing early-stage investment documents, including equity incentive plans, has resulted in the wide-spread adoption of equity incentive plans without much thought given to them. However, certain early-stage companies, often those raising capital from less sophisticated investors, plan to be aggressive with their equity award grants, at times (rightfully or wrongfully), to employee and non-employee directors. If that is the intention of the board of directors, then the equity incentive plan should specify limits on the maximum number of equity awards permitted to be granted to directors as a whole under the plan. Given that the Delaware courts have not distinguished between limits on grants to directors as a whole rather than individually, there appears to be no benefit to imposing limits on individual directors.

Notably, the Delaware courts rejected the need for "meaningful limits," in favor of "specific limits," on the number of equity awards that may be granted under a plan for the plan to be deemed ratified. Therefore, there appears to be no limit on the number of awards under a plan that may be granted to any specified beneficiary or class of beneficiaries that would prevent the stockholder ratification of the grants. That being said, any equity award grant remains subject to review for waste, and excessive grants may constitute waste.

The requirement that the stockholders' approval of the equity incentive plan must be fully informed magnifies the importance of disclosure regarding the plan. If the board of directors has made any determinations regarding the number and timing of equity awards that will be awarded to certain directions, then they should be disclosed to the stockholders.

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