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IN THE SUPREME COURT OF THE STATE OF DELAWARE

IN RE INVESTORS BANCORP, INC. STOCKHOLDER LITIGATION	))))))))	No. 169, 2017 Court below: Court of Chancery of the State of Delaware Consolidated C.A. No. 12327-VCS

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APPELLANTS' OPENING BRIEF

May 25, 2017

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NATURE AND STAGE OF THE PROCEEDINGS

This is an appeal of the Court of Chancery's dismissal of Plaintiffs' Complaint under Court of Chancery Rules 12(b)(6) and 23.1. After conducting a books and records inspection pursuant to 8 *Del. C.* § 220, Plaintiffs filed a derivative action seeking to recover over $50 million in excessive compensation that twelve corporate directors paid themselves in a self-interested transaction. On August 12, 2016, the Court appointed Plaintiffs as Co-Lead Plaintiffs and their counsel as Co-Lead Counsel. Defendants moved to dismiss on September 7, 2016.

The Court of Chancery dismissed the Complaint because the directors conducted their self-dealing under a companywide equity plan that "included director-specific limits that differed from limits that applied to awards to other beneficiaries under the plan," and the stockholders' prior approval of the plan thus "extended to the awards themselves, which indisputably fell within the limits set by the plan." (Memorandum Opinion ("Op." or "Ex. A") at 2). Alternatively, the Court of Chancery dismissed under Rule 23.1 the claims concerning the over $30 million in compensation granted to the company's two executive directors, finding that a majority of directors were disinterested with respect to that compensation.

SUMMARY OF ARGUMENT

1. The Court of Chancery based its Rule 12(b)(6) dismissal on the stockholders' prior approval of a broad-based equity plan authorizing the company's board of directors to provide incentive-based compensation for nearly 2,000 eligible participants. That plan included a "limit" of $114 million worth of shares on the amount directors could award themselves. In holding that stockholder ratification occurred under these circumstances, the Court of Chancery departed from decades of well-established law. The compensation plan the directors used for their $50 million self-dealing transaction essentially afforded them "blank check" authority, a degree of discretion that in turn should require them to meet the traditional standard of entire fairness that applies to such transactions, just as directors have had to do in prior cases involving similar plans. Displacing this precedent, the Court of Chancery has created a vast safe harbor mandating the application of business judgment review for all director self-dealing transactions made under omnibus compensation plans with *any* type of "limit" for directors that is separate from limits that apply to other plan participants.

2. In finding that the stockholder vote on the compensation plan was fully informed, the Court of Chancery did not consider the totality of the Complaint and declined to draw reasonable inferences in Plaintiffs' favor. The Complaint alleges through particularized facts that Defendants sought stockholder

approval of the plan without disclosing their explicit intention to "allocate" shares to themselves as soon as the plan was approved. As a result, Defendants' partial and generic disclosures concerning the plan's purposes were materially misleading.

3. The Court of Chancery's Rule 23.1 dismissal is erroneous as well. The particularized allegations of the Complaint, which are derived from Defendants' own documents, demonstrate the existence of a single self-dealing transaction, in which the directors by their own admission "allocated" to themselves – non-employee and executive directors alike – over $50 million of stock. The Defendants' unanimous participation in this conflicted transaction renders demand futile as a matter of law.

STATEMENT OF FACTS

Plaintiffs purchased Investors Bancorp's stock on May 7, 2014. (A025 ¶ 13). Nominal Defendant Investors Bancorp is a Delaware corporation and holding company for Investors Bank (the "Bank"), a New Jersey chartered savings bank. (A025-26 ¶ 14). When the Complaint was filed, the Company had a twelve-member Board, comprising ten non-employee directors[1] and two executive officers, Domenick A. Cama ("Cama"), Chief Operating Officer and Senior Vice President, and Kevin Cummings ("Cummings"), Chief Executive Officer ("CEO") and President. (A026-28 ¶¶ 15-27; A030 ¶ 33).

A. Investors Bancorp's Mutual-to-Stock Conversion

Investors Bancorp is the successor to a company of the same name that completed its initial public stock offering on October 11, 2005 ("Old Investors Bancorp"). (A028 ¶ 28). On December 17, 2013, the Bank, Old Investors Bancorp and its parent company, Investors Bancorp, MHC ("MHC"), each adopted a Plan of Conversion and Reorganization in which MHC ceased to exist, and the Bank reorganized into a fully public stock holding company (the "Mutual-to-Stock Conversion," or "MSC"). (A028-29 ¶¶ 28-29). On May 7, 2014, the MSC was

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[1] Robert C. Albanese, Dennis M. Bone, Doreen R. Byrnes, Robert M. Cashill ("Cashill"), William V. Cosgrove, Brian D. Dittenhafer ("Dittenhafer"), Brendan J. Dugan, James J. Garibaldi, Michele N. Siekerka, and James H. Ward III.

completed when Investors Bancorp conducted its second-step public offering. (A029 ¶ 30).

B. The Board adopts the Equity Incentive Plan

On March 24, 2015, the Board adopted the 2015 Equity Incentive Plan (A080-106) (the "EIP"), subject to stockholder approval at the Company's 2015 Annual Meeting of Stockholders. (A041 ¶ 62). In contemplation of avoiding certain regulatory requirements imposed by the Board of Governors of the Federal Reserve System (the "FRB") during the one-year period following a mutual-to-stock conversion, the Board chose to implement the EIP on May 8, 2015, exactly one year after the MSC was completed, "such that the FRB conversion rules would not apply[.]" (A042 ¶ 64).

The EIP is an omnibus equity plan with a ten-year term, under which 30,881,296 shares of common stock were reserved for various stock awards to the Company's approximately 2,000 officers, employees, non-employee directors, and service providers. (A081; A041 ¶ 63). The EIP does not establish any fixed or annual compensation for the Company's directors. Nor does it establish or restrict the total amount of compensation the directors can pay themselves. Section 3.3 of the EIP, entitled "limitations on grants to individuals," provides that (i) "employee[s] covered by [Internal Revenue] Code Section 162(m) ["Section 162(m)"]" may not receive in any calendar year more than 4,411,613 stock options and 3,308,710 restricted stock awards to the extent the options and restricted stock are "intended to be 'performance-based compensation' [under] Section 162(m)"; and (ii) "[t]he maximum number of shares of Stock that may be covered by Awards granted to all non-employee directors, in the aggregate, is thirty percent (30%) of the shares authorized under the Plan all of which may be granted during any calendar year." (A043-44 ¶ 68; A088-90). Thirty percent of the shares under the EIP is 9,264,388 shares, which were worth nearly $114 million when the EIP was proposed to stockholders. (A044 ¶ 68; A090).

C. The Board seeks stockholder approval of the EIP

According to Investors Bancorp's Schedule 14A Proxy Statement filed with the U.S. Securities and Exchange Commission (the "SEC") on April 30, 2015 (the "2015 Proxy"), the Board adopted the EIP to "provide additional incentives for [the Company's] officers, employees and directors to promote [the Company's] growth and performance," and its approval by stockholders would "give [the Company] the flexibility [it] need[s] to continue to attract, motivate and retain highly qualified officers, employees and directors by offering a competitive compensation program that is linked to the performance of [the Company's] common stock." (A042-43 ¶ 65). The 2015 Proxy further disclosed that "[t]he number, types and terms of awards to be made pursuant to the [EIP] are subject to the discretion of the [Compensation and Benefits] Committee [the "Compensation

Committee"] and have not been determined at this time, and will not be determined until subsequent to stockholder approval." (A043 ¶ 66). In addition to seeking approval of the EIP, the 2015 Proxy also disclosed each Board member's 2014 compensation, which was similar to what they received in 2013 and comparable to Investors Bancorp's peer group. (A030-31 ¶¶ 34-35; A032-34 ¶¶ 37-40; A035-36 ¶¶ 44-45; A037 ¶¶ 50-51). Based on these disclosures, stockholders approved the EIP on June 9, 2015. (A043 ¶ 67).

D. Defendants immediately make a self-interested "allocation" of shares under the EIP and award themselves more than $50 million in stock

On June 12, 2015, three days after the EIP was approved, the Compensation Committee met to "begin the process of determining the allocation of shares" under the EIP. (A046 ¶ 73). This was the first of four prearranged special purpose meetings to determine the "allocation," and the minutes of the June 12 meeting confirm that additional meetings were already scheduled for June 16, June 19, and June 23, 2015, in order to "deliberate" and "finalize" the Compensation Committee's "recommendation to the full Board at the June 23, 2015, Board of Directors meeting." (A046 ¶ 73). A majority of the Board, including Cummings and Cama, attended all four meetings, along with attorneys from Luse Gorman, PC ("Luse Gorman"), the Company's counsel, and Gregory Keshishian of GK Partners, Inc., a compensation consultant.

The second meeting was held on June 16, 2015 to "gather input from [the Company's] outside experts as well as compensation committee members to continue the committee's consideration as to allocation of awards under the [EIP]." (A046-47 ¶ 74). Luse Gorman presented a chart of 164 companies that had undergone a mutual-to-stock conversion during the preceding twenty years, which listed the number of stock options and stock awards received by executives and directors at these companies following the conversions.[2] (A047 ¶ 75; A054 ¶ 87).

"[T]he stated goal" of the third meeting on June 19, 2015 was "to have a thorough discussion of all the major decisions needed to be made in order to allocate shares under the [EIP]." Although the Company's disclosures state that Cummings and Cama "do not attend portions of [Compensation] Committee meetings during which their performance is being evaluated or their compensation is being determined," at the June 19 meeting Cama himself proposed the specific equity awards that he and Cummings were to receive in the allocation. (A047-48 ¶¶ 76-77). With Cummings and Cama present, each Compensation Committee

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[2] Plaintiffs calculated the dollar values for the awards issued by the sixty-one companies that have undergone mutual-to-stock conversions since January 1, 2008. The average award received by non-employee directors was $175,817. (A054 ¶ 86). Sixty of the sixty-one companies paid less than $1 million, fifty-six were under $400,000, and more than half were under $100,000. (A051-54 ¶ 85). For the same companies, the CEO and the next highest-paid executive received on average $898,490 and $510,435, respectively. (A061-64 ¶ 103). In comparison, Cummings and Cama together received over $30 million of awards, while the non-employee directors received over $2 million each, as set forth below.

member was “polled” as to their “view” on Cama’s recommendations and “responded in the affirmative.” (A048 ¶ 76).

At the final meeting on June 23, 2015, the “focus...was to approve all the components of the incentive stock and option grants for Directors and Management under the [EIP].” (A048 ¶ 78). With respect to Cama’s proposal, the Compensation Committee’s “deliberations” were “fairly short as the [Compensation] [C]ommittee was satisfied that the option grant levels were appropriate.” Next, the Compensation Committee approved the equity awards to the non-employee directors. (A049 ¶ 80). The entire Board then discussed, concurred with, and adopted the Compensation Committee’s “recommendations” of the “Equity Plan Allocations for Management and Directors.” (A049-51 ¶ 81).

In this transaction, the Board approved for themselves over $50 million in equity compensation, comprising (i) an award to Cummings of 1,000,000 shares of restricted stock and 1,333,333 stock options, with a total value of $16,699,999; (ii) an award to Cama of 800,000 shares of restricted stock and 1,066,666 stock options, with a total value of $13,359,988; (iii) awards of 150,000 shares of restricted stock and 250,000 stock options to each of Cashill and Dittenhafer, with a total value of $2,661,000 each; and (iv) awards of 100,000 shares of restricted stock and 250,000 stock options to each of the other non-employee directors, with a total value of $2,034,000 for each director. (A020-21 ¶ 3; A050-51 ¶¶ 82, 84; A060 ¶ 102).

According to the Company's Schedule 14A Proxy Statement filed with the SEC on April 14, 2016 (the "2016 Proxy"), these awards were made to reward the non-employee directors for their "role in completing the [MSC] in [May] 2014." (A021-22 ¶ 5). When combined with the average of $148,435 in regular compensation they previously approved for themselves, Investors Bancorp's non-employee directors paid themselves an average of $2,307,835 per director in 2015, making them the ten highest-paid directors among the approximately 175 non-employee directors in the Company's peer group, companies that paid their directors an average of $175,861. (A054 ¶ 88; A055 ¶ 90; A057 ¶¶ 92, 93).

Cummings and Cama's 2015 compensation was valued at $20,006,957 and $15,318,257, respectively, compared to the average of $4,124,637 and $4,170,814 that companies in Investors Bancorp's peer group paid their CEOs in 2014 and 2015, respectively. (A064-65 ¶¶ 105, 107). Cummings and Cama had previously received MSC-related bonuses in December 2013 and February 2014. According to the 2016 Proxy, the purpose of awarding them an additional $30 million following stockholder approval of the EIP was to "increase the[ir] share ownership" and "create a stronger link" between performance and "realizable pay." (A033 ¶¶ 39-40; A067 ¶ 111). These rationales are not mentioned in the Board materials discussing the "allocation," nor is the allocation plan mentioned in the 2016 Proxy. (A067-69 ¶¶ 111-112).

E. The Court of Chancery Dismisses the Complaint

Because Plaintiffs challenge a conflicted transaction, the Court of Chancery recognized entire fairness as "the default standard of review." (Op. 15). Defendants sought to shift the standard to business judgment by raising "the affirmative defense of stockholder ratification." (*Id.*). Thus, the "key issue in this case is whether the stockholder approval of the equity compensation plan extends to the board of directors' subsequent decision to authorize grants of awards under the plan such that the propriety of these awards should be reviewed under a waste standard." (Op. 1).

In answering this question, the Court of Chancery focused on "the language in the EIP that authorized up to 30% of the EIP's [total share] capacity [*i.e.*, 9,264,388 of the 30,881,296 shares] to be granted to non-employee directors," specifically Section 3.3(c). (Op. 11; A090). As distinguished from compensation plans that include "generic" limits that apply to "all plan beneficiaries," it is the existence of the EIP's "director-specific limit" that led the Court of Chancery to dismiss the Complaint: "Critically, th[e] [EIP] included director-specific limits that differed from the limits that applied to awards to other beneficiaries under the [EIP]." (*Id.* at 2). The Court of Chancery's conclusion was based on its reading of

Calma on Behalf of Citrix Sys., Inc. v. Templeton, 114 A.3d 563 (Del. Ch. 2015) ("*Citrix*"), the "most salient" aspect of which it found to be "the effect that 'director-specific' limits within a stockholder-approved equity compensation plan will have on the efficacy and reach of stockholder approval." (Op. 18). The Court of Chancery specifically explained its reading of *Citrix* as follows:

> Once the plan sets forth a specific limit on the total amount of options that may be granted under the plan to all directors, whether individually or collectively, it has specified the 'director-specific ceilings' that *Citrix* found to be essential when determining whether stockholders also approved in advance the specific awards that were subsequently made under the plan.

(Op. 22).

In addition, the Court of Chancery held that Plaintiffs "failed to identify any bases upon which the Court could reasonably infer that the stockholders' approval of the EIP was uninformed" because it was "not reasonably conceivable from the facts pled in the Complaint that the Board concealed from stockholders a preconceived plan to grant themselves equity awards under the EIP as soon as it was implemented." (Op. 29).

Lastly, with respect to the awards to Cummings and Cama, the Court of Chancery found that "Plaintiffs have not pled any particularized facts that would support a reasonable inference that the Board engaged in a unitary transaction such that a reasonable doubt has been raised regarding the independence or disinterestedness of a majority of the Board." (Op. 36). According to the Court of

Chancery, because "the votes of the executive officers were not necessary for the approval of the grant of awards to the non-employee directors," and the Complaint did not "plead facts that allow a reasonable inference that the non-employee directors received *something* in return for their approval of the grants to the Executive Director Defendants," dismissal was required under Rule 23.1. (*Id.* at 34 (emphasis in original)).

ARGUMENT

I. Delaware law does not support the Court of Chancery's finding that stockholder approval of the EIP ratified the challenged award of compensation

A. Question presented

Stockholder ratification is an affirmative defense to claims challenging a self-interested transaction, which shifts the standard of review from entire fairness to business judgment and immunizes defendants from all claims other than waste. The ratification defense requires defendants to prove that stockholders approved the specific transaction in a fair and fully informed vote. Did stockholder approval of the EIP, a companywide equity plan intended to provide incentive-based compensation for nearly 2,000 eligible participants and which contained a "director-specific limit" of $114 million in stock awards, ratify a subsequent transaction in which the company's twelve directors paid themselves annual compensation exceeding $50 million? (*See* A148-150).

B. Scope of review

The Rule 12(b)(6) dismissal is reviewed *de novo* to determine whether the Court of Chancery "erred as a matter of law in formulating or applying legal precepts." *Gantler v. Stephens*, 965 A.2d 695, 703 (Del. 2009) (citation omitted).

C. Merits of Argument

Contrary to well-settled law, the Court of Chancery's ruling provides directors with a license to engage in self-dealing, of any type and amount, as long as it is done under the auspices of a stockholder-approved omnibus compensation plan with a separate provision for directors. This new rule will encourage directors to use broad-based corporate compensation plans as a Trojan horse for excessive self-dealing and leave stockholders without a remedy.

As the Court of Chancery recognized, director compensation decisions are classic self-dealing transactions ordinarily subject to the demanding requirements of entire fairness review. (Op. 14-15, quoting *Telxon Corp. v. Meyerson*, 802 A.2d 257, 265 (Del. 2002)). Thus, in a case such as this one "[w]here the self-compensation involves directors or officers paying themselves bonuses, the court is particularly cognizant to the need for careful scrutiny" to protect against abuse. *Valeant Pharm. Int'l v. Jerney*, 921 A.2d 732, 745 (Del. Ch. 2007) (citation omitted).

A conflicted fiduciary can avoid entire fairness review by establishing that a majority of disinterested stockholders approved the challenged transaction in a fully informed and uncoerced vote, which in turn "leads to waste being the doctrinal standard of review for a breach of fiduciary duty claim." *Citrix*, 114 A.3d at 587. The polar opposite of entire fairness review, the standard for pleading waste is "an extreme test, very rarely satisfied by a shareholder plaintiff." *Steiner v. Meyerson*, 1995 WL 441999, *1 (Del. Ch. July 19, 1995). A waste claim will be dismissed if it is reasonably conceivable that the transaction serves a legitimate corporate purpose. *Id.*; s*ee also Citrix*, 114 A.3d at 590. Thus, a finding of stockholder ratification is effectively outcome-determinative. *See Singh v. Attenborough*, 137 A.3d 151, 151-52 (Del. 2016) (noting that "the vestigial waste exception has long had little real-world relevance").

In light of this, "Delaware law does not make it easy for a board of directors to obtain 'ratification effect' from a stockholder vote. The burden to prove that the vote was fair, uncoerced, and fully informed falls squarely on the board…[and] it is difficult for a board to prove ratification at the pleading stage." *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 899 (Del. Ch. 1999). "[I]n order for directors to access the safe harbor of ratification, they must meet an affirmative 'burden of demonstrating full and fair disclosure.'" *Sample v. Morgan*, 914 A.2d 647, 665 (Del. Ch. 2007), quoting *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 140-41 (Del. 1997). In addition, directors must establish that stockholders approved the specific action being challenged. *Citrix*, 114 A.3d at 586, 588; *see also Gantler*, 965 A.2d at 713 ("[T]he only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve").

1. The Court of Chancery misapplied the law of stockholder ratification for self-interested transactions under corporate compensation plans

The EIP is a broad-based compensation plan the Board adopted purportedly to provide incentive-based compensation for nearly 2,000 eligible participants. The EIP is not a director compensation plan. It does *not*: (i) apply exclusively to directors; (ii) set annual compensation levels for directors; (iii) provide directors with automatic or specific awards or payments; or (iv) impose any meaningful constraint on directors when administering the plan for their own benefit. Instead, Section 3.3(c) of the EIP provides that, over the lifespan of the plan, the Company's non-employee directors may not receive more than 9,264,388 shares of stock (worth over $114 million), "all of which may be granted in a calendar year." (A090).

Relying on this provision, the Court of Chancery determined that the existence of a separate "director-specific limit" in the EIP provided "the requisite level of specificity" to provide Defendants with business judgment protection when they paid themselves over $50 million in stock awards after the EIP was approved. (Op. 16). This result is inconsistent with how the ratification doctrine has been applied in cases involving compensation plans similar to the EIP. In this line of cases, directors were unable to avoid entire fairness review for conflicted transactions made within the broad terms of stockholder-approved plans because the plans did not define or limit the directors' ability to engage in self-dealing in any meaningful real-world sense. Instead, the plans entrusted directors with a form of "blank check" or "*carte blanche*" authority that was too broad to provide the self-dealing directors with business judgment protection. In departing from this line of cases, the Court of Chancery has dispensed with the qualitative approach to assessing compensation plans and adopted a "check-the-box" test for ratification, which eliminates the traditional protections of Delaware law for any self-dealing transaction directors engage in under a companywide plan with a separate "limit" for directors.

a. The EIP is a "blank check" compensation plan

In *Sample v. Morgan*, two non-employee directors awarded 200,000 shares of stock to three employee-directors under a stockholder-approved plan. 914 A.2d at 650. In moving to dismiss claims challenging the transaction, the "directors argue[d] that the doctrine of ratification bars the claims in the complaint because the stockholders knew that [the challenged transaction] was possible under the literal terms of the [plan]." *Id.* at 651. The court rejected this "frivolous" argument, finding that the stockholders' decision to authorize directors to distribute shares under the plan "cannot reasonably be interpreted as a license" for the directors "to do whatever they wished, unconstrained by equity." *Id.* at 651, 664. As the court explained the law:

> [T]he Delaware doctrine of ratification does not embrace a "blank check" theory. When uncoerced, fully informed, and disinterested stockholders approve a specific corporate action, the doctrine of ratification, in most situations, precludes claims for breach of fiduciary duty attacking that action. But *the mere approval by stockholders of a request by directors for the authority to take action within broad parameters does not insulate all future action by the directors within those parameters from attack*. . . . An essential aspect of our form of corporate law is the balance between law (in the form of statute and contract, including the contracts governing the internal affairs of corporations, such as charters and bylaws) and equity (in the form of concepts of fiduciary duty). *Stockholders can entrust directors with broad legal authority precisely because they know that that authority must be exercised consistently with equitable principles of fiduciary duty*.

Id. at 663-64 (emphasis added). Thus, although the challenged transaction was authorized under the plan stockholders had approved, stockholders remained entitled "to rely upon the policing of equity to ensure that that authority would be utilized properly." *Id.* at 664.

Five years later, in *Seinfeld v. Slager*, 2012 WL 2501105 (Del Ch. June 29, 2012), directors sought to dismiss claims challenging compensation they paid themselves by arguing that the compensation was permitted by a stockholder-approved plan "and that the [b]oard's decisions, therefore, are protected by the business judgment rule." *Id.* at *11. The plan in *Seinfeld* authorized the issuance of up to 10.5 million restricted shares to the company's officers, employees, and directors, while providing that no "eligible individual" was permitted to receive more than 1.25 million restricted shares – worth $21.7 million – during any fiscal year. *Id*.

The *Seinfeld* court refused to apply business judgment to the directors' self-dealing, finding that the compensation plan lacked "effective limits on the total amount of pay" because it provided directors with the "theoretical ability to award themselves as much as tens of millions of dollars per year, with few limitations[.]" *Id.* at *12. Echoing *Sample*'s repudiation of a "blank check" form of ratification, the court explained that "[a] stockholder-approved *carte blanche* to the directors is insufficient. . . . If a board is free to use its absolute discretion under even a stockholder-approved plan, with little guidance as to the *total* pay that can be awarded, a board will ultimately have to show that the transaction is entirely fair." *Id.* (emphasis in original).

Citrix is the most recent case to reject the "blank check" ratification theory. As in *Seinfeld* and as with the EIP here, in *Citrix* the beneficiaries of the compensation plan included directors, officers, employees, and advisors. The plan reserved 10.1 million shares in total and provided that no "one person" could receive more than 1 million shares in a calendar year – the equivalent of over $55 million. 114 A.3d at 570-71. In seeking dismissal, the "defendants contend[ed] that Citrix stockholders ratified the [p]lan so that any award[s] . . . to the directors" made within the parameters of that plan "must be reviewed under a waste standard." *Id.* at 569. Once again, the court disagreed, finding that "the upfront stockholder approval of the [equity plan] was not a 'blank check' or '*carte blanche*' ratification of any compensation that the [board] might award to [Citrix's] non-employee directors" after the plan was approved. *Id.* at 588. Rather, because stockholders were "simply asked to approve, in very broad terms, the [p]lan itself," and were not asked to approve "any *action specific to director compensation*," or stated similarly, "any *action bearing specifically on the magnitude of compensation for the [c]ompany's non-employee directors*," the entire fairness standard applied. *Id.* at 588 (emphasis in original).

As in *Seinfeld* and as with the EIP, the plan in *Citrix* "did not specify the amount or form of compensation to be issued to the [c]ompany's non-employee directors." *Id*. Instead, the plan broadly authorized payments as high as $55 million a year to any "one person." *Id.* Having "surveyed" six decades of ratification law in the context of director compensation, the *Citrix* court relied on *Seinfeld* as the "most analogous" precedent and found "no meaningful difference" between the Citrix plan's $55 million "limit" and the $22 million "limit" in *Seinfeld*. *Id*. at 584.

Prior to the ruling below here, directors had succeeded in obtaining business judgment protection for self-compensation in two situations: (1) when stockholders specifically approved the challenged compensation directly; and (2) when stockholders approved compensation plans that provided directors with automatic payments of fixed amounts or that otherwise imposed "meaningful" limits on the discretion of directors to pay themselves. These cases bear no resemblance to the circumstances here.

In *Cambridge Retirement System v. Bosnjak*, 2014 WL 2930869 (Del. Ch. June 26, 2014), the stockholders approved specific compensation packages for individual directors by voting in favor of separate proposals describing each director's compensation. *Id.* at *2, *7-8. The proposals – one for each director – disclosed the amount, exercise price, and vesting periods of the stock options that were later challenged by the plaintiff. *Id.* at *2. Although these transactions were "classic forms of self-dealing," and indeed "[even though] plaintiff has alleged facts suggesting that the amount of compensation paid to [the] directors may be excessive," the complaint was dismissed because the "stockholders cannot legitimately claim they were not made aware of the material terms of what they were being asked to approve." *Id.* at *9 (citation omitted). Similarly, in *Steiner v. Meyerson*, 1995 WL 441999 (Del. Ch. July 19, 1995), ratification occurred based on stockholder approval of a stock option plan specifically for non-employee directors that authorized each director to receive "an option to purchase 25,000 shares upon election to the [] board, and an additional 10,000 shares on the anniversary of his election while he remains on the board." *Id.* at *4, *7-8.

In addition to cases involving specifically approved individual compensation packages or self-executing director compensation plans, ratification has been recognized in cases involving plans that impose meaningful constraints on the directors' ability to provide themselves compensation. For example, in *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997), ratification was found where stockholders had approved an incentive compensation plan that provided each director with initial grants of 15,000 stock options to be followed by annual grants of up to 10,000 stock options based on the length of each director's service on the board. *Id.* at 329-30, 338. Two years later, in *In re 3COM Corp. S'holders Litig.*, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999), ratification was achieved based on stockholder approval of a director compensation plan with a specific and "meaningful limit" on the annual compensation for directors. In *3COM*, the challenged awards were made under a compensation plan exclusively for the company's non-employee directors, which included "specific ceilings on the awarding of options each year[,] . . . [which] differ based on specific categories of service – such as service on a committee, position as a lead director, and chairing the [b]oard." 1999 WL 1009210, at *3.

Given the precisely delineated parameters of the plan approved by stockholders, the *3COM* court held that the directors' compensation was protected by the business judgment rule. Unlike the wide discretion conferred by the plans in

Sample and its progeny, *3COM* was "a case where stock options *accrued* to [] directors under the terms of an established option plan with *sufficiently defined terms*," *i.e.*, the specific annual and service-based "ceilings" in a plan created for the specific purpose of providing compensation to the company's directors each year. 1999 WL 1009210, at *3 (emphasis added).

In *Seinfeld* the court referred to the "sufficiently defined terms" of the *3COM* plan as having imposed a "*meaningful* limit" on the "*total* pay" for directors. 2012 WL 2501105, at *12 (emphasis in original). In doing so, *Seinfeld* articulated an essential point for distinguishing plans that will garner business judgment protection from those that will not, which is that "[t]he sufficiency of definition that anoints a stockholder-approved option or bonus plan with business judgment rule protection exists on a continuum." *Id*. A plan with "broad parameters" – such as those involved in *Sample, Seinfeld,* and *Citrix* – represents one end of this continuum, where entire fairness squarely applies. *See Citrix*, 114 A.3d at 585 (noting that "the logic and reasoning of [*Sample* and *Seinfeld*] are aligned"). The ratification defense failed in *Seinfeld* because the plan provided "little guidance" on the amount of compensation directors could pay themselves – an assessment that likewise describes the plan in *Citrix* and the EIP in this case. 2012 WL 2501105, at *12.

Moving along this continuum in the other direction, "[t]he more definite a plan, the more likely it is that a board's compensation decisions will be labeled disinterested and qualify for protection under the business judgment rule." *Id.* Thus, stockholder ratification was recognized in *Steiner*, *Lewis*, and *3COM* for the same essential reason – the stockholder-approved plans were either effectively self-executing or imposed a real-world constraint on the directors' ability to enrich themselves. *See Citrix*, 114 A.3d at 581 ("Critical to the [] directors' ratification defense [in *Steiner*] was that the plan was, in effect, self-executing: it set forth the *specific awards* to be granted to the company's non-employee directors upon election to the board and annually thereafter. In other words, stockholder approval of the plan *per force* meant stockholder approval of the option awards for which the directors asserted a ratification defense.") (emphasis in original); *id.* at 582 ("Significantly, th[e] plan [in *3COM*] applied only to directors and set forth '*specific ceilings* on the awarding of options each year,' which varied 'based on specific categories of service[.]'") (emphasis in original).

The Court of Chancery did not discuss or cite the *Seinfeld* decision. After erroneously attributing the "meaningful limit" test to Plaintiffs' invention, the Court of Chancery rejected the concept entirely. It did not consider the total dollar value represented by any particular "limit" to be relevant in determining whether a compensation plan provides "*carte blanche*" authority to directors.[3] Instead, it found the "most salient" guidance to be gleaned from *Citrix* is that plans with "director-specific" limits provide business judgment protection while plans with "generic" limits for "all plan beneficiaries" garner entire fairness review. (Op. 18).

As illustrated below, the Court of Chancery's ruling upends Delaware law by assigning the standard of review based on the *words* employed by a plan in formulating a limit rather than the *substance* of that limit.

Case	**Limit**	**Dollar Value/Result**
Seinfeld	With respect to the shares of Common Stock reserved pursuant to this Section, a maximum of One Million Two Hundred Fifty Thousand (1,250,000) of such shares may be subject to grants of Performance Shares, Restricted Stock and Awards of Common Stock **to any one Eligible Individual** during any one fiscal year.	\$21.7 Million/ Entire Fairness
Citrix	*Per-Participant Limit*. Further, and subject to adjustment under Section 8.1, in no event shall the number of shares of Stock covered by Options or other Awards granted **to any one person** in any one calendar year exceed 1,000,000 shares of Stock.	\$55 Million/ Entire Fairness
Investors Bancorp	*Stock Options, Restricted Stock Awards and Restricted Stock Units - Directors.* The maximum number of shares of Stock that may be covered by Awards granted **to all non-Employee Directors**, in the aggregate, is thirty percent (30%) of the shares authorized under Plan all of which may be granted during any calendar year.	\$114 Million/ Business Judgment

[3] In delineating the raw number of shares reserved under the EIP for options and restricted stock and the maximum number of shares for directors and executive officers, the Court of Chancery concluded without explanation that these were "meaningful limits." (Op. 23-24). There is no discussion in the Court of Chancery's opinion of what these raw numbers have to do with the critical issue – the *magnitude* of director compensation.

As a result, a formalistic distinction has become outcome-determinative. According to this new approach, the law of prospective stockholder ratification for director self-dealing does not require anything beyond the separateness of a "director-specific" limit in an omnibus equity plan.[4] Under this framework, arbitrary results are inevitable. Indeed, if the EIP had reserved 9,264,388 shares for all plan participants without a director-specific limit, the Court of Chancery's analysis would have resulted in entire fairness review. But because the Board reserved 30,881,296 shares for all participants while also including a "director-specific" limit of 9,264,388 shares, the EIP was deemed to qualify for business judgment protection despite the fact that the limit applicable to directors is identical in both situations. However, nothing in *Citrix* suggests that business judgment review would have applied if the plan in that case, in addition to its "generic" annual limit of 1 million shares (which applied to everyone, including directors), also had a "separate" annual limit of 1 million (or 999,999) shares for directors. Again, there was no ratification in *Citrix* because "when the [b]oard sought stockholder approval of the broad parameters of the [p]lan and the generic limits specified therein," stockholders were "not asked to approve any *action specific to director compensation*" but were instead "simply asked to approve, in very broad terms, the [p]lan itself." 114 A.3d at 588 (emphasis in original).

[4] Regardless of what the "limit" is, whether or not it applies on an annual basis, to total compensation, or to individual directors or all directors as a group.

As another case decided shortly after *Citrix* makes clear, the Court of Chancery's approach is incompatible with the rationale underpinning stockholder ratification: a "meeting of the minds" between directors and stockholders. In *Larkin v. O'Connor et al.*, defendants adopted an omnibus compensation plan reserving a total of 3.6 million shares for awards to employees, officers, and non-employee directors. C.A. No. 11338-CB, at 69-71 (Del. Ch. Mar. 22, 2016) (TRANSCRIPT) ("*Larkin* Tr." or "Ex. B"). The plan included a "director-specific," indeed a per-director annual limit, of 200,000 shares, which were worth $4.5 million when the plan was adopted. *Larkin* Tr. 28-29.[5]

In seeking stockholder approval of the plan, defendants identified the specific awards granted to non-employee directors and stated that the awards were "contingent" on stockholder approval of the plan. *Id.* at 5-6. Defendants argued that stockholder approval of the plan ratified the "contingent" awards, resulting in business judgment protection. The court disagreed because no "specific approval was sought over the grants to the outside directors." *Id.* at 69-71. As the Chancellor explained:

> The law . . . is that for a ratification defense to be effective, there must be ratification of a specific decision. And what underlies that is the notion that there has to be a meeting of the minds . . . about what's actually being approved between, on the one hand, the company, . . .

[5] *See also* Advaxis, Inc.'s Schedule 14A Proxy Statement, filed with the SEC on April 7, 2015, Annex A at 15. (https://www.sec.gov/Archives/edgar/data/1100397/000149315215001278/def14a.htm).

> and, on the other hand, the stockholders who were asked to vote on something. There's got to be sufficient specificity so there is not ambiguity that they're agreeing to the same thing, basically.

(*Id*. 69-70.)

The ratification defense was not rejected in *Larkin* because the proxy proposal was "confusing" or "inverted." (Op. 22 n.25). It was rejected because, as in *Sample*, *Seinfeld*, and *Citrix*, it was not appropriate under the circumstances to find that stockholders approved anything besides the plan itself:

> There are lots of permutations you could read in from [this] vote[.] If the stockholders approve that plan, I presume it could mean one of three things. They were approving the plan. Maybe they're approving the grants that are enumerated under the plan. Maybe they're approving both. Not clear. . . . [F]rankly, the best reading is *they're just approving the plan*."

(*Larkin* Tr. 71 (emphasis added)).[6]

[6] The Chancellor's analysis is consistent with how courts have applied ratification in other contexts. *See Solomon v. Armstrong*, 747 A.2d 1098, 1113-14 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000) (Table) ("the Delaware Supreme Court has made it clear that ratification of one board action does *not* extend to any other actions which are not necessarily attendant to th[e] approved action") (emphasis in original), citing *In re Santa Fe Pacific S'holder Litig.*, 669 A.2d 59, 67-68 (Del. 1995); *In re Lukens Inc. S'holder Litig.*, 757 A.2d 720, 737 (Del. Ch. 1999), *aff'd sub nom., Walker v. Lukens, Inc.*, 757 A.2d 1278 (Del. 2000) (Table) (describing "problem" with ratification argument rejected in *Santa Fe* as "the incongruity between the proposal voted on" and what was alleged to have been ratified).

b. Limiting the scope of stockholder ratification to transactions stockholders have specifically approved serves important policy interests

In the Court of Chancery's view, to look beyond the fact that the EIP includes a separate limit for directors would be "antithetical to Delaware law" because it "would propel the court into a position where it was second-guessing the informed decision of stockholders to approve compensation for the company's directors and officers." (Op. 26 n.33). This reasoning begs the very question at issue – whether stockholders in fact "approved" the challenged compensation merely by voting in favor of the EIP. They did not. Stockholder approval of the EIP is "best understood as a decision by stockholders to give the directors broad legal authority [to grant compensation, including to themselves] and to rely upon the policing of equity to ensure that that authority would be utilized properly." *Sample*, 914 A.2d at 664. Ratification is a narrow doctrine and, for the reasons explained in *Sample*, it is wrong to conclude that when stockholders voted in favor of the EIP they *ipso facto* preapproved *all* potential self-dealing transactions involving $114 million worth of shares – including a one-time award of $114 million in shares to a single director, a subset of directors, or $14 million for each of them. But that is precisely what the Court of Chancery's ruling means.

Applying entire fairness does not "second guess" the Company's stockholders, who never approved the transaction in question. Rather, it vindicates the "[i]mportant policy considerations" that apply in the director self-compensation context. *Citrix*, 114 A.3d at 587. "Specifying the precise amount and form of director compensation in an equity compensation plan when it is submitted for stockholder approval 'ensure[s] integrity' in the underlying principal-agent relationship between stockholders and directors 'by making the directors suffer the ugly and enjoy the good that comes with a consistent, non-discretionary approach' to their compensation." *Id.*, quoting *Desimone v. Barrows*, 924 A.2d 908, 917 (Del. Ch. 2007). In the same vein, "obtaining stockholder approval of director compensation on an annual or regular basis facilitates the disclosure of inherently conflicted decisions and empowers stockholders with a meaningful role in the compensation of their fiduciaries." 114 A.3d at 587.

The Court of Chancery's ruling undermines these policies by creating an inflexible bright-line rule that will permit directors to convert broad grants of authority to administer stockholder-approved plans into a safe harbor of immunity for self-dealing, thus subverting the reasonable expectations of stockholders in approving these plans. This approach lacks any qualitative component and in practice will allow directors to claim that any compensation they pay themselves was preapproved by stockholders as long as the plan included some sort of "director-specific limit." Thus, the ruling will drastically curtail the availability of judicial review precisely where it is most needed, vastly diminishing the proper role of Delaware courts in applying the "policing of equity" to self-dealing transactions. This extreme hands-off approach is an especially unwarranted departure from precedent because the law already provides directors with a clear path to business judgment protection while also protecting stockholders.

2. In seeking stockholder approval of the EIP, Defendants concealed material facts about their plan to allocate shares for themselves

Because ratification also requires Defendants to prove "full and fair disclosure," the Court of Chancery separately considered whether the stockholder vote on the EIP was fully informed. (Op. 27, quoting *Sample*, 914 A.2d at 665). In concluding that this vote was fully informed, the Court of Chancery failed to consider the totality of Plaintiffs' allegations and did not draw reasonable inferences in their favor. (Op. 29).

First, the Complaint supports the inference that Defendants' allocation scheme was planned for over a year and did *not* begin three days after the EIP was approved or "in due course," as the Court of Chancery concluded. (*Id.* at 31). In dismissing any possibility "that the timing was somehow manipulated," the Court of Chancery fails to account for Plaintiffs' specific allegation that the existence of regulatory requirements led Defendants to delay the EIP until exactly one year after the MSC was completed on May 7, 2014. (*See* A042 ¶ 64, quoting internal memorandum showing that Defendants purposefully chose May 8, 2015 as the date to propose the EIP "such that the FRB conversion rules would not apply"). That the EIP "was approved at the first meeting of stockholders to occur after the plan was adopted" was not a coincidence, but a specifically timed step in Defendants' long-term planning. (Op. 29).

Second, the Court of Chancery's finding that "it is not reasonably conceivable . . . that the Board concealed from stockholders a preconceived plan to grant themselves equity awards . . . as soon as [the EIP] was implemented" cannot be reconciled with the reasonable inferences that flow from the specific allegations of the Complaint. (*Id*.). Whether the three-week period between approval of the EIP and Defendants' "allocation" was "a lengthy process" or not, the Complaint supports a reasonable inference that contradicts the Court of Chancery's determination that this process was "initiated by the Board after stockholder approval of the EIP." (*Id.* at 30). Three days after stockholders approved the EIP, the Board and its outside legal and compensation advisors held their first meeting to "'begin the process of determining the allocation of [awards]' under the [EIP]." (A046 ¶ 73). By this time the other three meetings comprising the Board's "process" for approving their allocation had already been scheduled, including meetings to receive "input regarding the awards from expert advisors," and to "finalize" the allocation. (Op. 30; A046-47 ¶¶ 73-74). The Court of Chancery overlooks these particularized allegations and draws the contrary (and unreasonable) inference that the entire schedule materialized in a day or two.

Third, the Court of Chancery's conclusion that "Plaintiffs have not alleged specific facts that the Board had agreed to make any specific awards prior to stockholder approval of the EIP or prior to undertaking the formal process of determining what awards should be made" misses the point. (Op. 30). The gravamen of the Complaint, which is told largely through Defendants' own documents, is that Defendants (i) decided to reward themselves for the MSC by making an "allocation" of shares as soon as the EIP was approved; and (ii) made that decision and completely mapped out the process long before they asked stockholders to approve the EIP.

The Court of Chancery suggests that none of this makes any difference, because "[b]ased on the disclosures in the Proxy, the stockholders knew that once the EIP was approved the Board could immediately choose to make awards, including to directors." (Op. 31). *Sample* emphatically rejects the notion that ratification can be achieved merely because directors tell stockholders what could or might happen if a particular plan is approved. As in *Sample*, the Defendants' documents describe "an allocation plan that suggests it was contemplated from the get-go" that Defendants would reward themselves for the MSC as soon as the EIP was approved, an undisclosed fact that "would clearly be of relevance to a reasonable investor." *Sample*, 914 A.2d at 666. In light of this omission, the Board's "generic, partial" disclosure that the EIP was intended to provide incentives for nearly 2,000 different potential beneficiaries over time "is materially misleading." *ODS Techs., L.P. v. Marshall*, 832 A.2d 1254, 1261 (Del. Ch. 2003).

While the inadequacy of Defendants' disclosures would be even more striking if Defendants had made the disclosures in seeking stockholder approval of the awards *after* they were made, there is no reason why these same disclosures should be deemed adequate in the "preapproval" context of advance stockholder ratification. To the contrary, demonstrating full and fair disclosure in the "plaintiff-friendly environment of a Rule 12(b)(6) motion" is meant to be an "onerous task." *Sample*, 914 A.2d at 665.

Defendants only attempt to carry their disclosure burden was to point back to May 1, 2014, over a year before stockholders were asked to approve the EIP, when the Company issued the MSC offering prospectus, a 237-page document which is not referenced in the 2016 Proxy or the Complaint. In doing so, Defendants directly undermine their position. Specifically, while defending the disclosures in the 2016 Proxy on the basis that it was not possible for Defendants to have disclosed awards that had not yet been made, Defendants also claimed that in the May 2014 prospectus they "expressly told stockholders of the Company's plans to issue restricted stock and stock options [to the directors] in the future once an equity incentive plan had been adopted and approved." (Op. 28). To say the least, the (untrue) "we already told them" argument is an awkward complement to Defendants' primary position that "there was nothing to tell" and effectively concedes the fatal deficiency of the information Defendants actually presented to stockholders when asking them to approve the EIP.

II. Demand is excused because Plaintiffs challenge a single transaction in which the entire Board is interested as a matter of law

A. Question Presented

Demand is excused under Rule 23.1 when a complaint alleges particularized facts showing that a majority of a board of directors is interested in the transaction being challenged. Is demand excused here, where the Complaint alleges that the entire Board structured and executed a self-dealing transaction for the stated purpose of "allocating" among themselves – non-employee and executive directors alike – over $50 million in stock awards? (Op. 33-36).

B. Scope of Review

Review of a dismissal under Rule 23.1 is *de novo* and plenary. *Gatz v. Ponsoldt*, 925 A.2d 1265, 1274 (Del. 2007).

C. Merits of the Argument

When, as here, a derivative claim concerns a decision made by a board of directors, demand futility is established by particularized allegations raising a reason to doubt that (1) a majority of the board of directors is disinterested and independent, or (2) the decision was a valid exercise of business judgment. *Aronson v. Lewis*, 473 A.2d 805, 811-812 (Del. 1984); *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993). In making this inquiry, the court (i) considers the allegations of the complaint collectively; (ii) assumes all well-pled allegations to be true; and (iii) draws all reasonable inferences in plaintiff's favor. *See Del. Cty.*

Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1019 (Del. 2015); *Harris v. Carter*, 582 A.2d 222, 229 (Del. Ch. 1990).

The decision of apparently independent directors to award compensation to executive officers is normally subject to business judgment, unless the complaint alleges that a majority of the board of directors is not disinterested with respect to that compensation, *e.g.*, by claiming the executive compensation was part of a *quid pro quo* involving a majority of the directors. *See In re National Auto Credit, Inc. S'holders Litig.*, 2003 WL 139768, *9 (Del. Ch. Jan. 10, 2003) (viewing executive and director compensation "as a single, interrelated set of transactions, authorized as a *quid pro quo* in determining whether reasonable doubt exists as to the disinterestedness" of each director); *Metcalf v. Zoullas*, 2012 WL 169874, *4 (S.D.N.Y. Jan. 19, 2012) (finding demand futile based on *quid pro quo* allegations).

To allege demand futility in this context, a complaint must contain particularized facts from which it can be "reasonably inferred that [the directors' conduct] constituted a single, self-interested scheme." *National Auto Credit*, 2003 WL 139768, at *9. In making this determination, a form over substance approach should be rejected so that faithless directors cannot "too easily render their malfeasance immune from [judicial review]" simply by manipulating the form of related transactions. *Metcalf*, 2012 WL 169874, at *4.

In dismissing under Rule 23.1, the Court of Chancery noted that the non-employee directors comprised a majority of the Board capable of approving their own awards and thus did not "need[] the votes of the [two] executive officers." (Op. 34). Similarly, it found that Plaintiffs failed to "plead facts that allow a reasonable inference that the non-employee directors received *something* in return for their approval of the grants to [Cummings and Cama]." (Op. 34). Demand should have been deemed excused, however, because the Complaint does in fact allege "that the Board engaged in a unitary transaction." (Op. 36).

Based on their pre-suit investigation, Plaintiffs uncovered documents establishing the existence of a *single conflicted transaction* that Defendants assembled in a unified effort to enrich themselves. Specifically, the Complaint alleges through particularized facts that (i) after taking their regular annual compensation, the Board held a series of special purpose meetings to "allocate" shares for themselves under the EIP; (ii) Cummings and Cama attended these meetings, and Cama himself proposed the awards that he and Cummings received; and (iii) the Board materials confirm that the shares allocated to each Defendant were "components" of a single transaction commemorating the MSC. (A049-50 ¶ 81).

While the Court of Chancery could not identify a specific "trade" among Defendants, demand is excused when the particularized allegations of the complaint show, as they do here, that each director engaged in the same misconduct.[7] In this situation, "[i]t strains reason to argue that a defendant-director could act independently to evaluate the merits of bringing a legal action against any of the other defendants if the director participated in the *identical challenged misconduct*." *Needham v. Cruver*, 1993 WL 179336, *2-3 (Del. Ch. May 12, 1993) (emphasis added); *see also Noerr v. Greenwood*, 1997 WL 419633, *9 (Del. Ch. July 16, 1997) (demand excused based on "a unified scheme to provide all board members with [stock] options").

[7] The "trade" Defendants made involves an intangible commodity – a mutual indifference to the largesse others received in the same transaction that enriched all of them.

CONCLUSION

For the foregoing reasons, the Court of Chancery erred in holding that the Company's stockholders ratified the challenged transaction and in dismissing the claims under Rule 12(b)(6). It further erred in finding that demand was not excused with respect to the claims subject to Rule 23.1 The Order of the Court of Chancery should be reversed and remanded for further proceedings.

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