Delaware Supreme Court Affirms Court of Chancery's Dismissal of Claim Relating to Alleged Violation of Stock Incentive Plan

Client Alert
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In an order issued on March 6, 2015 in *Friedman v. Khosrowshahi*, the Delaware Supreme Court affirmed the Court of Chancery's dismissal of a breach of fiduciary claim relating to an alleged violation of Expedia's stock incentive plan. The Supreme Court upheld the Court of Chancery's finding that the complaint failed to allege any violation of the Plan because (1) the board acted on a reasonable interpretation of the Plan's terms and (2) to the extent the terms of the Plan were ambiguous, the Plan expressly gave the board authority to resolve any ambiguity.

As the Court of Chancery had noted, *Friedman* involved "a seemingly increasing area of litigation" in the Court of Chancery: claims challenging the payment of compensation to an officer or director of a Delaware corporation based on an alleged violation of the terms of a compensation plan. At issue in the case was a grant of restricted stock units to the chief executive officer of Expedia. Under the Plan, Expedia's compensation committee was authorized to grant tax-deductible restricted stock awards to employees. The Plan required such awards to be contingent on one or more specified "performance goals," which were defined under the Plan as goals established by the Committee that are intended to meet the tax-deductible requirement under the tax code. The Plan also stated that each award would vest only upon the achievement of one or more performance goals, together with the satisfaction of any other conditions as the Committee may determine to be appropriate. The Plan authorized the Committee to amend any awards previously granted, provided the amendment did not affect the tax-deductible status of the awards. Importantly, the Plan gave the Committee the authority "to interpret the terms and provisions of the Plan and any award issued under the Plan."

The awards at issue were subject to an operating income target in addition to other conditions that satisfied the tax deductible requirements under the tax code. The Committee subsequently waived the operating income target. The plaintiff brought a derivative action alleging that the Committee

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breached its fiduciary duty of loyalty when it waived the Plan's operating income target requirement with respect to the chief executive officer's RSUs.

On July 16, 2014, the Court of Chancery granted the defendants' motion to dismiss because the plaintiff failed to plead with particularity that making a demand would have been futile. Under the well-established two-prong test articulated in *Aronson v. Lewis*, where a decision of a board of directors is challenged, demand is excused if particularized facts have been alleged to create a reasonable doubt either that (1) the directors are disinterested and independent or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. Prior decisions from the Court of Chancery have held that the second prong of *Aronson* is satisfied, thereby excusing a pre-suit demand in a derivative action, where the plaintiff had sufficiently alleged a "clear or intentional violation" of a compensation plan approved by stockholders.

In *Friedman*, the Court of Chancery rejected the plaintiff's demand futility argument and held that the plaintiff had failed to assert allegations sufficient to infer a clear or intentional violation of the Plan. The Court of Chancery noted that the Committee was authorized under the Plan to waive the operating income target because such target was not intended to satisfy the performance goal requirement of the tax code and, at most, the plaintiff raised a potential ambiguity, which the Committee was entitled to interpret and resolve under the Plan. The Court also held that the plaintiff failed to plead facts creating a reasonable inference that a majority of the board was interested or lacked independence.

The Delaware Supreme Court affirmed the Court of Chancery's ruling because (1) "the board of directors acted on a reasonable interpretation of [the Plan's] written terms" and (2) "to the extent that the terms were ambiguous, the Plan *expressly gave the board the authority* to resolve any ambiguity itself." The Supreme Court's Order is noteworthy because it demonstrates that a provision in a compensation plan granting authority to the board or a committee thereof to interpret the terms of the plan or any award thereunder can be useful in overcoming a claim that the board or committee intentionally violated the plan.

Furthermore, the Supreme Court's Order raises an interesting question for practitioners to consider. Traditionally, claims that directors breached their fiduciary duties by violating the terms of stockholder-approved compensation plans have been asserted derivatively as breach of fiduciary duty claims, which require a demand excusal analysis. The Supreme Court suggested that if such claims are brought as contract claims they may be subject to a different demand analysis. Specifically, the Supreme Court noted that Court of Chancery decisions "arguably conflict" on the issue of whether a stockholder-plaintiff must plead demand excusal "if her claim is a breach of a stockholder-approved plan as a contract, and she seeks recovery under contract law.

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