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Client Alert

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DE Court: Informal NYSE Guidance May Not Be a Defense in Fiduciary Duty Lawsuit

In a recent bench ruling, the Delaware Court of Chancery refused to dismiss a stockholder's complaint alleging, among other things, that a company's board of directors had amended a stock incentive plan without obtaining stockholder approval as required by the listing rules of the New York Stock Exchange ("NYSE"). The court did so even though the company had received email confirmation from the NYSE staff agreeing that stockholder approval was not required. The court found that, given the "fundamental" nature of the amendment, the plaintiff stated a claim that stockholder approval was required under NYSE Listing Rule 303A.08 and, therefore, the board lacked authority to amend the stock incentive plan. The court also questioned whether the company had disclosed enough facts to the NYSE to allow its staff to make an informed decision. The court's ruling undermines a fairly common practice for seeking the NYSE's guidance on a wide variety of governance issues.

Background

The case, *Louisiana Municipal Police Employees Retirement System v. Bergstein*, concerns a $120 million grant of long-term incentive plan (or "LTIP") performance units to the chief executive officer of Simon Property Group, Inc.[1] In connection with the grant, the board of directors amended the company's stock incentive plan to authorize the issuance of performance units that vested over time, subject to the chief executive officer's continued employment. As alleged by the plaintiff, the original plan, which was previously approved by the company's stockholders, limited performance units to those that could be earned based on attainment of specified performance goals. The plan provided that the board of directors could amend it without stockholder approval unless such approval was required by law or applicable stock exchange rules.

Prior to the amendment, the company sought informal guidance from the NYSE staff on whether the amendment required stockholder approval under the NYSE Listing Rules. Specifically, NYSE Listing Rule 303A.08 requires stockholder approval to any "material revision" to an equity-compensation plan. The listing rules include a non-exclusive list of amendments that require stockholder approval, including "[a]n expansion of the types of awards available under the plan." The NYSE's Frequently Asked Questions on Executive Compensation Plans further explain that a revision would be material if it materially increases the potential dilution of the company's stockholders or has a similar effect to any of the listed examples.

In an email to the company, the NYSE staff agreed that the proposed amendment did not require stockholder approval under NYSE Listing Rule 303A.08. As a result, the company amended the stock incentive plan without stockholder approval and issued the performance units. A public pension fund then filed a derivative suit challenging the transaction. It also bears noting that the company's stockholders rejected the company's non-binding "say on pay" vote at its 2012 annual stockholders meeting. In addition, the incentive grant attracted negative press and was criticized by the proxy advisory firms.

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[1] *Louisiana Mun. Police Emp. Ret. Sys. v. Bergstein*, C.A. No. 7764-CS, trans. ruling (Del. Ch. May 30, 2013).

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Court's Ruling

In ruling from the bench on the defendants' motion to dismiss, Chancellor Leo E. Strine, Jr., refused to dismiss the plaintiff's complaint. He focused on the fact that the amendment, which previously permitted only performance-based awards, changed the plan so that the company could issue "service-based" awards. He labeled this change as "fundamental" and referred to the "service-based" awards as "salary."

In reaching his decision, Chancellor Strine noted that the use of "service-based" awards appeared to deviate from the company's prior public disclosures, which allegedly emphasized a "pay-for-performance" compensation philosophy. He stated that:

> When you tell stockholders up front they're voting on a plan that has performance units based on performance goals, and that they get to vote on any material changes, and then by board action alone, the performance units are turned into simply an aspect of a recipient's salary package, I cannot conclude on a pleading stage motion that that is not a material change.

Importantly, Chancellor Strine did not give any deference to the informal guidance provided to the company by the NYSE staff. He characterized the NYSE staff's email as "off-the-cuff" and contrasted it with the more "formal" no-action letters provided by the staff of the Securities and Exchange Commission ("SEC"):

> I'm not saying that people don't give you comfort, but you sort of get what you ask for, which is it might be a second nod but, ultimately, it's an email.[2]

He also focused on the short timeframe in which the NYSE staff offered guidance, noting that the company emailed the NYSE staff on Friday and received a response the following Monday. Given the preliminary nature of the litigation, however, it was not clear whether the company had held prior conversations with the NYSE staff about the proposed amendment.

In addition, Chancellor Strine questioned whether the company had provided sufficient detail to the NYSE for its staff to make an informed decision. He noted that, as alleged by plaintiffs, the NYSE was not aware of the $120 million grant-date value of the performance units, that the performance units were being issued to the chief executive officer, or that the company previously touted its pay-for-performance culture.

Implications

The NYSE does not have a formal process for seeking definitive guidance on how to comply with its listing rules. Seeking informal guidance from the NYSE's staff by phone or email, however, is common for NYSE-listed companies on a wide variety of governance issues arising under the NYSE Listing Rules. The court's ruling is thus noteworthy because it shows that courts may not defer to such guidance, which places listed companies in a difficult position. It also shows how courts can, indirectly through a stockholder lawsuit, enforce stock exchange listing rules. As the defendants argued to the court, the

[2] *See also id.* at 100 ("So there is a utility to this kind of informal guidance, but it's really important for the public that it not be distorted because it's only as good as — you know, the formality you seek has a consequence for you. And in this sort of situation, I believe probably the exchange would view it as, 'You took your risk.'").

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NYSE had not conducted any inquiry into the amendment or otherwise expressed concern following the announcement of the lawsuit.

The ruling also illustrates the potential importance of disclosure to the NYSE in seeking interpretative guidance. The plaintiffs alleged, and the court agreed on the preliminary record, that the company disclosed few details of the proposed amendment and thus prevented the NYSE from considering the issue in context. The court may have been more deferential if the company's email request to the NYSE had contained more information.

The court's distinction between the NYSE's informal guidance and the SEC's no-action letter process also warrants comment. The court was correct that a no-action letter generally gives issuers a high level of comfort. While the internal procedures vary slightly among the different SEC divisions and offices that provide no-action and similar interpretive relief, each generally requires that a registrant submit in writing a detailed summary of facts and analysis of the law, which is then vetted by SEC staffers with oversight from their supervisors.[3] Attorneys, accountants and compliance professionals who submit material to the SEC are subject to its rules of practice and potential SEC discipline for violations of those rules. Any person who submits a materially false, fictitious, or fraudulent statement or representation to the SEC could also be subject to criminal liability under 18 USC § 1001. Nevertheless, we note that absent an explicit statement to the contrary, a no-action letter has no precedential effect on other registrants facing similar or even identical facts. To the contrary, SEC staff pronouncements (as opposed to those coming from the full Commission) are entitled to no *Chevron* deference, and depending on the circumstances, courts may afford no-action letters and other SEC staff commentary no precedential weight at all.

Companies should also take note that the plaintiff did not argue that the grant of performance units constituted "waste" that fell outside the protections of the business judgment rule. Rather, the plaintiff alleged that, while compensation decisions may be business judgments, the board's discretion was constrained by the express terms of the stock incentive plan and the NYSE Listing Rules, both of which allegedly required stockholder approval for the amendment. In addition, because this action allegedly was outside the board's authority, the court concluded that demand was excused for purposes of plaintiff's derivative suit.

Finally, the decision reveals the importance of SEC disclosures generally with respect to executive compensation. In today's environment, issuers remain hyper-focused on emphasizing the "pay-for-performance" aspects of their executive compensation scheme. In this case, the company's prior disclosures led the court to conclude that the "service-based" awards constituted a significant change in the company's compensation practices. It is not clear, however, whether Chancellor Strine would have reached the same result if the company's prior disclosures were different.

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[3] We distinguish a formal request for interpretive or no-action relief from the less formal procedures by which registrants or their advisors can seek informal or anonymous guidance from the SEC staff through phone calls or emails.

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