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Delaware Case Raises Question About Structuring Director Compensation

A recent opinion of the Delaware Chancery Court, *Seinfeld v. Slager*,[1] addresses the legal standard applicable to directors' decisions about their own pay under Delaware law, an important topic as to which there is little prior law. In an opinion by Vice Chancellor Glasscock, the Court held that a derivative claim alleging that directors breached their fiduciary duties by granting themselves excessive compensation survived a motion to dismiss.[2] In so concluding, the Court also found that the directors' action did not have the protection of the business judgment rule and was instead subject to "entire fairness" review.

The Court's decision to require "entire fairness" review means that the claim of excessive compensation could proceed to a full evidentiary trial on the merits. Under Delaware law, a court will not second-guess business judgments of directors if the directors acted in good faith, exercised due care and were not conflicted in the matter. When the business judgment rule does not apply, the judgments may be subject to heightened scrutiny under the entire fairness standard. To meet this standard, the directors must demonstrate that both the process undertaken by directors and the amount of their compensation are fair to the company.

In analyzing the proper standard of review, the *Seinfeld* Court factually distinguished *Seinfeld* from a similar claim dismissed in *In re 3COM Corp. Shareholders Litigation*, a 1999 opinion by then-Vice Chancellor Steele (who is now, of course, Chief Justice of the Delaware Supreme Court).[3] Both cases involved stockholder-approved equity plans, but the plan in *3COM* included only narrow discretion granted to the directors to determine the size

[1] *Seinfeld v. Slager*, 2012 WL 2501105 (Del. Ch. Jun. 29, 2012).

[2] The Court dismissed four other claims for corporate waste and breach of fiduciary duty in connection with executive compensation paid by Republic Services, Inc., the nominal defendant corporation. Plaintiffs did not make a demand on the board in respect of any of the claims. In respect of the excessive director compensation claim, demand futility was not argued by the defendants, presumably on the basis that the directors were clearly interested in the transaction. See *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

[3] *In re 3COM Corp. Shareholders Litigation*, 1999 WL 1009210, at 1 (Del. Ch. Oct. 25, 1999). For a similar claim involving cash, rather than equity-based, compensation, in which the Delaware Supreme Court also held that an entire fairness analysis would be applicable to directors' decisions about their own compensation, see *Telxon Corp. v. Meyerson*, 802 A. 2d 257, 265 (Del. 2002). For various reasons, including listing standards, public company equity plans are typically submitted for shareholder approval, whereas director cash fee plans and arrangements are typically not.

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of their annual awards, whereas the plan in *Seinfeld* included only customary individual and aggregate limits on the size of awards.

How different were the plans? The aggregate number of shares authorized under the plan in *Seinfeld* was 10,500,000 shares, and the individual limit was 1,250,000 shares per year. The stock had a value of approximately $25 per share at the time that the contested *Seinfeld* awards were granted, so that the maximum annual stock grant for directors was, technically, in the range of $30 million at the time. Clearly, these were not intended to be guidelines for actual award levels; in fact, during the two years in dispute, the board in *Seinfeld* decided to grant themselves restricted stock units worth about $750,000 and $215,000, respectively. By contrast, under the *3COM* plan, directors were eligible to receive awards of options to purchase up to 60,000 shares (up 80,000 shares for the chairman, plus up to 24,000 shares for committee service) every two years. The *3COM* stock had a value of about $40 per share at the time the contested *3COM* awards were granted. The actual grants for one of the fiscal years at issue in *3COM* ranged from 22,500 shares to 70,000 shares per director, which the opinion states had a Black-Scholes value alleged to be at least $650,000 per director.

The generic limits in *Seinfeld* were not sufficient to overcome plaintiffs' assertion that the self-interest of directors called for heightened scrutiny. The *Seinfeld* Court found that the plan at issue "lacked sufficient definition" for the rule in *3COM* to apply, stating that "there must be some meaningful limit imposed by the stockholders on the Board for the plan to be consecrated by 3COM and receive the blessing of the business judgment rule, else the 'sufficiently defined terms' language of 3COM is rendered toothless. A stockholder-approved *carte blanche* to the directors is insufficient."[4]

Directors of course routinely set their own compensation[5] and, in the post-SOX era, director compensation has generally increased in line with director responsibilities.[6]

[4] *Seinfeld*, at 12.

[5] *See* D.G.C.L. § 141(h) ("Unless otherwise restricted by the certificate of incorporation or bylaws, the board of directors shall have the authority to fix the compensation of directors."). *See also* NYSE Listed Company Manual § 303A.09, which provides that listed companies must adopt corporate governance guidelines that must address, among other things: "Director compensation. Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The board should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary. Similar concerns may be raised when the listed company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. The board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director." We note also that director compensation has not so far been a significant factor in proxy advisory firm voting recommendations.

[6] *See*, *e.g.*, Frederick W. Cook, Inc. 2011 Director Compensation: Non-Employee Director Compensation Across Industries and Size, at http://www.fwcook.com/alert_letters/2011_Director_Compensation_%20Non-Employee_Director_Compensation_Across_Industries_and_Size.pdf ("As companies gain a better understanding of the increased responsibilities and perceived personal risk for directors, we anticipate that director compensation levels may increase at [a] more rapid pace over the next several years.").

Seinfeld suggests that additional care in making director compensation decisions may be appropriate to mitigate litigation risk in an area that inherently involves self-interested dealings. It also raises the obvious question of whether companies should adopt and seek shareholder approval of plans that specify, in sufficient detail to be likely to qualify for business judgment rule protection, the amount and type of compensation to be paid to their directors. That approach requires a judgment about the trade-off between the greater legal certainty to be obtained through shareholder approval against the loss of flexibility such approval entails, which judgment would be made against an historical backdrop of few shareholder claims alleging excessive director compensation. Regardless of the approach taken, board members should be aware of the scrutiny that their compensation decisions will draw as compensation continues to be a focus for investors and governance gadflies.

If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under “Corporate Governance” or “Executive Compensation and ERISA” under the “Practices” section of our website at http://www.clearygottlieb.com.

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