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"[R]ather than giving the directors the benefit of the business judgment rule, . . . the court in Seinfeld *said the stock plan under consideration lacked "sufficient definition" to afford the directors that protection."*

DEFENDING DIRECTORS' STOCK GRANTS

By
John L. Utz
Utz & Lattan, LLC
jutz@utzlattan.com

Suing a company's board of directors for waste relating to compensation decisions is like throwing a tantrum. You do it when you are mad, you temporarily make another's life unpleasant, but you rarely do much good. As the Delaware Chancery Court recently said "[a] plaintiff . . . alleging waste arising from the decision of an independent board concerning employee compensation has set himself a Herculean, and perhaps Sisyphean, task." That is because if the company has received any substantial consideration from the employee in exchange for the compensation, and the board has made a good faith judgment that the compensation arrangement was worthwhile, a claim for waste will fail. That will be true even if in hindsight the compensation decision ultimately appears to have been ill-advised.

But for a plaintiff wishing to challenge a board's decision about *its own members'* compensation, there is another avenue to pursue (besides a claim for waste). That is a claim that the board breached its duty of loyalty in paying itself excessive compensation. Often even these claims are short-circuited – that is, dismissed early – because a board's decisions as to its own members' compensation are typically protected from challenge under the "business judgment" rule. A recent decision of the Delaware Chancery Court, *Seinfeld v. Slager*, 2012 Del. Ch. LEXIS 139 (Del. Ch. 2012), has, though, raised concern about the process for determining directors' compensation. The case has caused some to wonder whether omnibus stock plans should set separate limits for director grants (that is, separate from the limits for grants to employees) or whether director plans should be altogether separate from a company's omnibus plan for employees.

In *Seinfeld*, a shareholder brought suit – purportedly derivatively on behalf of the corporation – against the company's directors (as well as against certain officers with respect to other claims). In the claim that has garnered attention, the plaintiff argued that the directors paid themselves excessive compensation. Specifically, the plaintiff alleged that in 2009 the board gave each director (other than the CEO) time-vesting restricted stock units worth $743,700. This allegedly brought the directors' individual annual compensation to between $843,000 and $891,000. In 2010, the board allegedly again gave each of the directors (other than the CEO) restricted stock units worth $215,000, bringing the directors' individual annual compensation to between $320,000 and $345,000.

Importantly to the court, the awards were made under a stock plan that put "few, if any, bounds on the Board's ability to set its own stock awards." The plan committee, comprising the directors themselves, had the sole discretion over how to set director compensation under the plan – that is, how to compensate the directors themselves. As to restricted stock, the limitations imposed upon the board under the plan were that the board could only award

10.5 million shares total, and award an eligible individual 1.25 million shares a year. The court seemed to treat these restricted stock limits as applicable to the RSUs under consideration (perhaps conflating restricted stock and RSUs). The court noted that assuming there were 12 directors, this meant the board could theoretically have awarded each director 875,000 restricted stock units. Using the share value listed in the company's proxy statement filed on April 1, 2009, the maximum annual award to each director would then be worth almost $21.7 million, and the maximum total value for the board per year would be roughly $260 million. These numbers were, of course, not realistic because the plan (and its limits) covered employees as well as directors, and the directors in fact did not make awards to themselves at a level anywhere approaching these limits.

In determining whether to let the plaintiff proceed with his lawsuit, a big question for the court was whether the directors' RSU award decisions were entitled to the protection of the business judgment rule. If so, in the absence of waste (that is, a total failure of consideration), the directors would not have breached their duty of loyalty. If, though, the Board was not entitled to the protection of the business judgment rule, the directors would need to be able to show that the amounts they awarded themselves were "entirely fair." In that event, the directors' motion to dismiss the plaintiff's claim at an early stage would be denied.

Now we come to the bit of a surprise that has some talking. The court, in a favorable decision more than a dozen years ago, *In re 3COM Corp. Shareholders Litigation*, 1999 Del. Ch. LEXIS 215 (Del. Ch. 1999), concluded that "decisions of directors who administer a stockholder approved director stock option plan are entitled to the protection of the business judgment rule, and, in the absence of waste, a total failure of consideration, they do not breach their duty of loyalty by acting consistently with the terms of the stockholder approved plan." Well, that is just what happened in *Seinfeld*. That is, the directors followed a shareholder approved stock plan in making awards to themselves. The surprise was that rather than giving the directors the benefit of the business judgment rule, as one might have expected given the teaching of the *3COM* decision, the court in *Seinfeld* said the stock plan under consideration lacked "sufficient definition" to afford the directors that protection. The court distinguished the *3COM* decision, saying that the plan there included meaningful limits on the board imposed by the stockholders. In contrast, the court said there were no effective limits on the total amount of pay that could be awarded through time-vesting restricted stock units under the plan under consideration in *Seinfeld* since the directors could theoretically have awarded themselves RSUs worth as much as tens of millions of dollars per year, with few limitations. As a result, the court permitted the plaintiff to continue with his lawsuit challenging the directors' compensation decisions, and said the directors would need to show that the amounts they awarded themselves were "entirely fair."

Interestingly, the decision in *3COM* – which would have seemed to provide support for the directors, and which the court in *Seinfeld* distinguished – did not seem to place great weight on the parameters of the stock option plan at issue there. The plan in *3COM* was a directors' stock option plan (not an omnibus plan that contemplated employee awards). The court said the strictures of that plan included specific ceilings on the awarding of options each year, with those ceilings differing based on specific categories of director service, such as service on a committee, position as a lead director, or chairing the board. But the *3COM* court said little more about the particulars of the plan's limits, making one wonder how important they were to the court.

The *Seinfeld* court did not indicate how constrained a board must be under a stockholder approved stock plan to enjoy the protection of the business

Utz & Lattan, LLC

Overland Park Office:
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Skokie Office:
10024 Skokie Blvd.
Suite 213
Skokie, IL 60077-9944

Phone: 224.233.1342
Fax: 913-685-1281

Huntsville Office:
P.O. Box 1547
Huntsville, AR 72740

Phone: 479-738-1083
Fax: 913-685-1281

Katherine Utz Hunter
kutz@utzlattan.com
Phone: 224.233.1342

Lisa H. Lattan
lisalattan@utzlattan.com
Phone: 913.685.8150

Dale K Ramsey
dramsey@utzlattan.com
Phone: 479-738-1083

John L. Utz
jutz@utzlattan.com
Phone: 913.685.7978

www.utzlattan.com

judgment rule when awarding itself compensation under the terms of the plan, but did say the following:

> The more definite a plan, the more likely that a board's compensation decision will be labeled disinterested and qualify for protection under the business judgment rule. If a board is free to use its absolute discretion under even a stockholder-approved plan, with little guidance as to the *total* pay it can be awarded, a board will ultimately have to show that the transaction is entirely fair.

Lesson. The adverse ruling in *Seinfeld* for the company's directors does not mean those directors will ultimately lose the lawsuit. It does, though, mean they will need to prove that their compensation was entirely fair.

If a company were able to place separate limits on awards to directors under an omnibus plan, or possibly maintain a separate plan for directors only, where those limits are not unreasonably high and yet provide the flexibility needed by the board, doing so might be worth considering. In that event, shareholder approval of the plan might avoid the need to prove the directors' compensation is entirely fair. Instead, directors might then enjoy the protection of the business judgment rule with respect to any awards made to themselves under the terms of the plan. The problem, of course, is that we do not know how high the limits on director awards could be while remaining "sufficiently defined" so as to cause the Delaware Chancery Court to apply the business judgment rule. This may nonetheless be an effort worth undertaking, if for no other reason than to bring some additional discipline to the thought process relating to director compensation.

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Utz & Lattan, LLC

Overland Park Office:
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Skokie Office:
10024 Skokie Blvd.
Suite 213
Skokie, IL 60077-9944

Phone: 224.233.1342
Fax: 913-685-1281

Huntsville Office:
P.O. Box 1547
Huntsville, AR 72740

Phone: 479-738-1083
Fax: 913-685-1281

Katherine Utz Hunter
kutz@utzlattan.com
Phone: 224.233.1342

Lisa H. Lattan
lisalattan@utzlattan.com
Phone: 913.685.8150

Dale K Ramsey
dramsey@utzlattan.com
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jutz@utzlattan.com
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