New court ruling, new need for caution

In structuring director compensation, corporate boards face added scrutiny.

BY DOUG RAYMOND

NAVIGATING potential conflicts of interest can be challenging for directors, particularly in the current environment, where many are skeptical of the loyalty of directors to the best interests of stockholders. Challenges to board actions often focus on claims that directors have compromised the interests of the stockholders for their own personal benefit. A recent Delaware case highlights the risks that boards face when taking action that may benefit themselves, even if the same action would not have raised eyebrows a few years ago.

For many years, the business judgment rule has protected directors against challenges to their actions. Under this doctrine, in general, courts will not second-guess the decisions of corporate boards unless the decision is potentially influenced by a conflict of interest or the gross negligence of the board. However, the Delaware Court of Chancery recently denied business judgment deference to a board's decision to grant equity incentive awards to board members, even though the plan under which the awards were granted had been approved by stockholders.

The case, *Seinfeld v. Slager*, was brought by shareholder plaintiffs challenging executive compensation decisions made by the board of Republic Services Inc., a public company that provides waste management services. While the court dismissed most of the claims, it allowed one claim to proceed — that the directors had breached their fiduciary duties by giving themselves awards under the company's equity incentive plan. As a consequence, the defendant directors would have to establish at trial that the awards they granted themselves were entirely fair to the company. This is a level of judicial scrutiny more challenging, and surely more expensive to defend in litigation, than the business judgment rule. The case illustrates the pitfalls of today's governance environment, particularly in the area of board compensation, where boards historically had significant latitude.

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The result in *Seinfeld* came as a surprise to many. In 1999, the Chancery Court had dismissed a similar claim in *In re 3Com Corp. Shareholders Litigation,* holding that corporate directors who administer a stockholder-approved director stock option plan are entitled to the protection of the business judgment rule, absent corporate waste or a total failure of consideration, which would be unlikely to exist except in the most egregious of circumstances. In reaching a different result in *Seinfeld,* the court observed that the Republic Services directors had virtually unbounded discretion over how to compensate themselves. The only restrictions were quantitative: an aggregate maximum of 10.5 million shares and an individual limit of 1.25 million shares. The court noted that the plan gave the Republic Services directors "the theoretical ability to award themselves as much as tens of millions of dollars per year, with few limitations." Indeed, the court calculated that, assuming 12 directors, the directors could theoretically have awarded themselves restricted stock units worth $21,691,250 per director, with a total value of $260,295,000, while staying within the plan's limits. The *Seinfeld* opinion distinguished the 3Com stock plan as having better defined terms, with parameters that confined the board's discretion to issue awards.

The *Seinfeld* court opined that a plan that gave a board the freedom "to use its absolute discretion, with little guidance as to the total pay that can be awarded" could not be "labeled disinterested and qualify for protection under the business judgment rule." Consequently, the board that exercised such discretion would "ultimately have to show that the transaction is entirely fair" to the company, and do so in a courtroom.

While not discussed in the opinion, it is not clear how this differs from the practice of boards setting their own cash compensation for board service, which, like the plan in *Seinfeld,* is generally subject entirely to the discretion of the board, absent corporate waste or a total failure of consideration.

These are not easy days for boards. A great benefit of the protection of the business judgment rule is the freedom it gives boards to operate without being second-guessed in a courtroom. Putting the burden on the board to demonstrate that their actions are "entirely fair" inevitably creates an incentive for some to litigate these issues, and consequently, creates the necessity of developing a comprehensive record to support the board's decision. In any event, boards should be cautious in making decisions regarding their own compensation, and in the future directors should consider whether to submit specific limitations on their own compensation program, both cash and equity, to the stockholders for approval. ■

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