

Delaware Court Applies Entire Fairness Standard to Director Equity Grants

July 12, 2012 | Client Update | 4-minute read

In the midst of the focus on executive compensation litigation, a recent Delaware opinion serves as a reminder that stockholder approval of at least some portion of director compensation may be beneficial in subsequent litigation, particularly if the approval results in the application of the “business judgment rule.” However, as described below, uncertainty remains about the level of detail concerning director compensation that is necessary in a stockholder-approved plan to warrant the application of that rule. Companies and their boards will want to balance the desire to increase the likelihood that compensation decisions will be protected by the business judgment rule with the understandable preference to preserve flexibility in establishing director compensation. Director compensation remains an item to consider for a company (whether an existing public company or an IPO-ing company) that is seeking approval of a new or amended equity compensation plan.

On June 29, 2012, Vice Chancellor Glasscock of the Delaware Court of Chancery handed down a decision in [*Seinfeld v. Slager*](#), a stockholder derivative suit focusing on executive and director compensation. The Court dismissed all claims against the defendants except for a claim that certain director equity awards constituted corporate waste.

The director equity awards challenged were granted under the company’s broad-based equity compensation plan, which was a typical stockholder-approved plan with a plan-wide limit on the number of shares available for grant, as well as an annual cap on awards that could be granted to any participant (including directors). The plaintiff argued that, because the director defendants awarded themselves the compensation under the plan, they were interested in the transaction and thus Delaware’s heightened “entire fairness” standard applied. Defendants, in turn, argued that because (a) the compensation plan was approved by the company’s stockholders, and (b) the plaintiff did not allege that the awards violated the terms of the stockholder-approved plan, the business judgment rule applied.

Vice Chancellor Glasscock distinguished the earlier [*In re 3COM Corp. Shareholders Litigation*](#), which had accorded business judgment rule treatment to director awards granted under a stockholder-approved plan with specific annual limits for categories of director service, by finding that, in *3COM*, there were “sufficiently defined terms,” whereas, in the present case, there were “no effective limits on the total amount of pay that can be awarded.”

Interestingly, Vice Chancellor Glasscock elaborated, “The sufficiency of definition that anoints a stockholder-approved option or bonus plan with business judgment rule protection exists on a continuum. Though the stockholders approved this plan, 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 A stockholder-approved *carte blanche* to the directors is insufficient. 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.”

While it remains to be seen how the plaintiff’s claim will be decided on the merits, Vice Chancellor Glasscock’s decision underscores the long-standing corporate law principle that self-dealing/interested transactions generally are subject to the heightened entire fairness review.

As to whether and how to implement changes in equity compensation plans going forward, the potential litigation benefits will need to be weighed against the need for flexibility to react to such factors as changes in the market for director compensation. For example, the articulated “continuum” approach to stockholder approval of director compensation in *Seinfeld* raises the possibility that approval of specific annual grants (as in *3COM*) may not be necessary, but makes it clear that more specificity is better in terms of defending subsequent litigation.

As an aside, and in favor of the defendants, Vice Chancellor Glasscock also reaffirmed a point related to executive compensation that is worth noting here. Citing to Vice Chancellor Noble's recent opinion in [*Freedman v. Adams*](#), Vice Chancellor Glasscock reiterated that there is no general fiduciary duty to minimize taxes. In other words, a board may have reason to pay compensation that is not deductible as a result of Section 162(m) of the Internal Revenue Code, which restricts compensation deductions for payments made to a company's CEO and other executives under specified circumstances.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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