Seinfeld and Director Compensation: A Decision That Wasn't About Nothing

Companies should take the time to review their current equity incentive plans and make a reasoned decision as to how, or whether, to respond to the recent Seinfeld *decision on director compensation.*

As companies prepare for the upcoming proxy season, the recent Delaware decision in the *Seinfeld* case offers a cautionary note for boards as they consider director equity and incentive awards and the terms of the plans under which they are issued. In the decision, VC Glasscock, while dismissing a number of other plaintiffs' claims regarding compensation matters, found that the award to directors of time-vesting restricted stock units under the terms of the company's stockholder approved equity plan was an interested party transaction and therefore subject to review under the stringent entire fairness standard.

Until *Seinfeld*, boards of directors generally believed they were protected by the fairly lenient business judgment rule when granting themselves awards under stockholder approved plans. In the 1999 Chancery Court decision *In Re 3COM*, then VC Steele held that the business judgment rule should apply to director option grants so long as the grants were made under a plan that had been previously approved by stockholders and had "sufficiently defined terms". The court stated, "[o]ne cannot plausibly contend that the directors structured and implemented a self-interested transaction inconsistent with the interests of the corporation and its shareholders when the shareholders knowingly set the parameters of the Plan, approved it in advance, and the directors implemented the Plan according to its terms."

In finding that the board in *Seinfeld* was interested in the equity grant, VC Glasscock focused on the "sufficiently defined terms" requirement from *3COM* and found that the plan in question lacked the definition and limitations necessary to allow the board's compensation decision to qualify for business judgment rule protection, notwithstanding prior stockholder approval of the plan. To illustrate that the plan lacked "sufficiently defined terms", the court noted that the only limitations in the plan were caps on grants of 10,500,000 shares in total and 1,250,000 shares a year to any one eligible individual (which included officers, directors and employees). Given that the restricted stock units awarded had a value of approximately $25 per share at the time of grant, and assuming a 12 member board, the board could (very) theoretically award each director up to 875,000 restricted stock units — for a grand total of approximately $22 million in awards per director.

While the actual director awards considered by the court were only in the hundreds of thousands of dollars, VC Glasscock found that to be beside the point. Because the stockholder approved plan under which the grants were made could theoretically allow the directors to award themselves an exorbitant sum, they therefore were not operating under a sufficiently defined plan and were interested in the decision to make awards (regardless of whether the actual awards themselves were reasonable on their face). In questioning the board's reliance on the plan, VC Glasscock said, "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, else the 'sufficiently defined terms' language of *3COM* is rendered toothless."

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Deciding how to react to the *Seinfeld* decision, if at all, in the upcoming proxy season will be a fact-specific inquiry based on each individual company's circumstances (i.e., determining a "meaningful limit" will involve a different analysis for each company based on factors including the size of the business, the amount of work involved with being a board member and the practices of comparable companies). Companies that are already preparing to submit a new plan or plan amendment for stockholder approval this year (e.g., for 162(m) purposes or in connection with an increase in the number of shares authorized to be issued under the plan) may wish to consider whether to include in the plan a "meaningful" limitation on the amount of awards that can be granted to directors (which would understandably likely be different than the limit applicable to senior executives). The decision of whether to amend a plan solely in response to *Seinfeld* is a more difficult one — primarily weighing the time and effort to amend a plan, and to seek stockholder approval of that amendment, against the potential risk of challenges to director grants in the future. Regardless of whether their plan is otherwise up for approval, a company may take a wait-and-see approach to *Seinfeld*, deciding to rely on the reasonableness of individual grants to survive any potential challenges to those grants (although noting that, as in *Seinfeld*, it may prove difficult to obtain dismissal of claims at preliminary litigation stages if the more probing entire fairness standard is determined to apply). Although the ultimate course of action will inevitably vary based on each company's specific circumstances, including the assessment by companies not incorporated in Delaware as to whether the courts in their respective jurisdictions may take a different approach to these issues, companies should take the time to review their current equity incentive compensation plans and make a reasoned decision as to how, or whether, to respond to the *Seinfeld* decision.

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