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Corporate Litigation:

Stockholder Challenges to Executive Compensation

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Investors, proxy advisory services and corporate governance watchdogs closely monitor executive compensation, and express their views on executive pay in diverse fora, ranging from advisory say-on-pay votes required under the Dodd-Frank Act to a CEO Salary Watchdog Facebook page. Compensation decisions nevertheless remain a core function of a board of directors. A stockholder derivative plaintiff challenging most board decisions regarding executive compensation or severance payments confronts a pleading Everest. To avoid dismissal, a plaintiff challenging board decisions about the value of an executive's services usually must allege particularized facts that raise reasonable doubt about whether the board acted within the bounds of broad business judgment discretion afforded to it on compensation matters.

In a recent decision addressing stockholder derivative claims challenging a variety of compensation-related decisions as waste, Delaware Vice Chancellor Sam Glasscock III in *Seinfeld v. Slager*[1] reaffirmed the stringent requirements for a plaintiff to state a claim for most challenges to compensation. In a ruling that introduces uncertainty about the level of detail a stockholder-approved equity compensation plan needs in order to qualify director decisions to award themselves equity for business judgment deference, however, the court held that a board's decision to award directors equity bonuses under a stockholder-approved plan will be evaluated for entire fairness, i.e., both the process and the amount of compensation are fair to the company, if the plan lacks sufficiently defined terms and limits on the authorized awards.

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Review of Executive Compensation

Unless restricted by the certificate of incorporation or bylaws, section 141(h) of the Delaware General Corporation Law authorizes the board of directors to fix compensation for directors and officers of the corporation. When it comes to decisions on executive compensation or severance payments, the business judgment rule affords directors great deference, recognizing that "[i]t is the essence of business judgment for a board to determine if a particular individual warrant[s] large amounts of money, whether in the form of current salary or severance provisions."[2] At bottom, the personal services of executives and directors are assets bought and sold in a negotiated market. Courts have widely recognized that the value assigned to these services "is a matter best determined by the good faith judgments of disinterested and independent directors, men and women with business acumen appointed by stockholders precisely for their skill at making such evaluations."[3]

Courts ordinarily will evaluate compensation decisions under the standards applicable to corporate waste, which provides "a residual protection for stockholders that polices the outer boundaries of the broad field of discretion afforded directors by the business judgment rule."[4] The standard for pleading corporate waste is "extreme" and "very rarely satisfied by a stockholder plaintiff"; it requires particularized facts supporting a reasonable inference that the board authorized an exchange so one-sided that no business person of sound judgment could conclude that the corporation has received adequate consideration.[5]

Director decisions regarding how to compensate themselves, including with equity awards, obviously involve self-interest. With limited exception, in order to safeguard against potential dilution resulting from equity-based awards, the NYSE's Listed Company Manual requires that stockholders be given the opportunity to vote on all equity compensation plans and material revisions thereto. Delaware law generally extends business judgment deference to directors who administer a shareholder-approved stock incentive plan within its stated terms, including when directors award themselves equity compensation under the plan.[6] Self-interested directorial compensation decisions made without independent protections such as a stockholder-approved plan, like other interested transactions, are subject to entire fairness review.

'Slager'

Plaintiff in *Slager* challenged as waste five separate compensation decisions by the Board of Republic Services, Inc.: (i) authorization of certain payments to the company's then-CEO pursuant to a retirement agreement entered into in June 2010 under which the CEO agreed to retire on Jan. 1, 2011; (ii) approval of an incentive payment to the CEO that was not tax-deductible, and allegedly rendered the company's compensation plan not tax-deductible; (iii) grants of equity to themselves; (iv) awards of restricted stock to certain senior executives pursuant to a stockholder-approved Stock Incentive Plan; and (v) awards of employee bonuses that allegedly did not meet the requirements of a merger-related bonus plan. The director defendants moved to dismiss all claims for failure to state a claim and for failure to make presuit demand or plead particularized facts demonstrating demand futility, except for the director excessive compensation claim for which they did not dispute that demand was excused.

Because plaintiff challenged affirmative decisions made by the board, the two-part test articulated in *Aronson v. Lewis*[7] controlled his assertion that demand on the board was excused as futile. Under Aronson, a plaintiff must plead particularized facts that raise a reasonable doubt either (i) that a majority of the directors who approved the transaction in question were disinterested and independent, or (ii) that the transaction was the product of the board's good faith, informed business judgment. Turning to the challenged payments, the court first addressed plaintiff's challenge of a board decision to approve company payments to the departing CEO of (i) $1.8 million that was not required by his employment agreement, and (ii) $1.25 million, the full amount of the CEO's target long-term incentive award for 2009-2011, as agreed in his retirement agreement with the company.

Rejecting plaintiff's argument that the $1.8 million bonus to a departing employee was neither contractually required nor reasonable in light of the services previously rendered, the court emphasized that an informed and disinterested board decision to award a severance or retirement bonus is entitled to full business judgment deference. A board of directors may have a variety of reasons to award an executive a bonus for services already rendered. For example, awarding retroactive compensation to certain employees who remain with the company may encourage them to continue their employment. In the context of a retiring employee, "the award may serve as a signal to current and future employees that they, too, might receive extra compensation at the end of their tenure if they successfully serve their term. Other factors may also properly influence the board, including ensuring a

smooth and harmonious transfer of power, securing a good relationship with the retiring employee, preventing future embarrassing disclosure and lawsuits, and so on."

Under this framework, the court concluded that the board approved the bonus "as part of a package intended to secure a general release, to provide continuity in the Board, and to ensure that [his] separation from the Company was amicable," which was more than sufficient to bar a waste claim.

Plaintiff next contended that the $1.25 million payment to the CEO on his retirement constituted waste because it failed to comply with the requirements for deductibility under §162(m) of the Internal Revenue Code, which would render the company's entire stockholder-approved Employee Incentive Plan non-tax deductible. Generally, §162 allows a company to deduct "a reasonable allowance" for employee compensation but restricts compensation deductions for a company's CEO and its four highest-compensated officers. For these senior "Covered Employees," §162(m) provides that annual compensation in excess of $1 million is not tax-deductible unless the compensation is granted pursuant to a performance-based, stockholder-approved plan that contains pre-established, objective criteria. Except in case of death, disability or change of ownership or control, Treas. Reg. §1.162(e)(2)(v) elaborates that when "the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained," compensation is not tax deductible.

As an initial matter, the court recognized that there are a variety of reasons why a company may choose or not choose to take advantage of certain tax savings. Noting that countless board decisions may implicate the company's tax position (e.g., decisions about capital structure, when to purchase capital goods, where to locate its operations and whether to rent or buy real property), the court emphasized that the rarely satisfied waste standard is the proper boundary when evaluating a board's tax-related decisions. Accordingly, the court ruled that a board's good faith decision to pursue or forgo tax savings generally is a managerial decision entitled to business judgment deference.

The parties disputed the significance of a 2008 IRS Revenue Ruling which, applying Treas. Reg. §1.162(e)(2)(v), ruled that compensation is not performance-based (and therefore not tax-deductible) if a Covered Employee receives any of his performance compensation regardless of whether he actually achieves the performance goal. Under this ruling, "a plan like that applicable to [the CEO],

which provides for full bonuses upon retirement, as if performance goals had actually been met, is not tax-deductible." Recognizing that some existing plans would run afoul of this rule, the IRS adopted a grandfathering provision, under which its new position would apply prospectively only, and not disallow a deduction for compensation that otherwise satisfies the requirements for qualified performance-based compensation if (among other things) "the performance period for such compensation begins on or before January 1, 2009."

The CEO's 2009 employment agreement tracked the provisions of the Revenue Ruling 2008-13: for performance periods that began pre-Jan. 1, 2009, the agreement provided that he would be paid the full amount of his potential bonus, at target. For subsequent periods, it provided (as the revenue ruling required) that he would receive only his pro rata share of what he would have been paid had the performance goal in question been attained. The court rejected as "facially unsound" plaintiff's argument that the IRS exceeded its power by allowing companies to enter into new agreements after the ruling was issued, providing for payment in full at retirement as long as the performance period began pre-Jan. 1, 2009. Rather, analyzing a waste claim arising from a board attempt to navigate IRS guidance, it was clear that in negotiating the CEO's contracts the board had carefully followed IRS guidance and reasonably attempted to preserve tax deductions for the company. The "decision of an independent board to rely, in setting compensation, on a revenue ruling of the IRS, is within the business judgment of the board," precluding a waste claim arising from that decision.

Plaintiff next asserted waste arising from awards approved by the board under the company's stockholder-approved Stock Incentive Plan, which allowed the company to grant stock awards to its employees, officers and directors. The plan also authorized the board to decide whether restricted stock or stock units awarded under the plan should vest based on the achievement of pre-set performance goals or the passage of time. The board chose to make time-vested awards of restricted stock to board members and to certain employees, which precluded the company from taking a tax deduction for those awards.

The court accorded business judgment deference to the decision to award time-vesting stock units to employees, which qualified as "quintessential Board decisions: how much to pay employees and how to allocate company assets efficiently." That higher taxes were paid because of the decision to award time-vesting stock did not support a waste claim. The court also rejected plaintiff's challenge to the board's award of the maximum amount of "synergy bonuses"

authorized under a stockholder-approved plan adopted to incentivize and reward cost improvements following a merger, concluding that the complaint offered no factual basis to believe that the Board deviated from the terms of the plan, or that no rational director would approve payments made under the plan.

In a ruling that introduces uncertainty about the level of detail a stockholder-approved equity compensation plan needs in order to obtain business judgment deference for director decisions to award themselves equity, the court declined to dismiss the waste claim challenging amounts the directors awarded themselves. Plaintiff asserted that the board overpaid itself by awarding directors too many time-vesting restricted stock units in 2009 and 2010. The Stock Incentive Plan authorized an aggregate of 10.5 million shares, and an individual 1.25 million shares a year. The awards approved by the board did not approach the boundaries.

The restricted stock units granted to the directors had a value of approximately $25 per share at the time of the awards. In 2009, the board awarded each of the directors $743,700 in restricted stock units, which raised their compensation for 2009 to between $843,000 and $891,000. In 2010, the board awarded each director 7,500 restricted stock units, valued at $215,000, which brought their 2010 compensation to between $320,000 and $345,000 each. Plaintiff claimed that director compensation in these years far exceeded the compensation paid to directors at the company's largest competitor, and therefore constituted waste.

In what was surely a result-altering determination, the court ruled that the board's decisions concerning the directors' own compensation were not entitled to the protection of the business judgment rule, but subject to entire fairness review. Equity compensation has long been recognized as a legitimate tool for motivating and retaining a company's directors, officers and employees, but with limits. The cardinal principle is that the stated terms of the plan must be followed. Delaware law rejects, for example, a waste claim based on the board's repricing of options where the stockholder-approved plan contemplated repricing as a performance incentive for directors.[8] In *Ryan v. Gifford*,[9] however, then-Chancellor William Chandler III held that demand was excused in an options backdating case because the plaintiffs had alleged facts showing that the directors had deliberately violated the express provisions of a stockholder-approved incentive compensation plan, which prohibited backdating. He concluded that a board's intentional decision to "exceed the shareholders' grant of express (but limited) authority raises doubt regarding whether such decision is a valid exercise of business judgment and is sufficient to excuse a failure to make demand" under *Aronson's* second prong.

By contrast, in *In re 3Com Corp. S'holders Litig.*,[10] then-Vice Chancellor Myron Steele applied business judgment review and dismissed a waste claim based on stock options directors granted to themselves where the only factual allegation was that the options had a value that was "quite large (at least $650,000 per director)." The 3Com stockholder-approved equity compensation plan capped the number of shares that could be granted for each type of board service each year: maximums of 60,000 shares for board members, 80,000 for the chairman and 24,000 for service on a board committee. Within this framework, the grants to 3Com directors unsuccessfully challenged as waste were between 22,500 and 45,000 shares.

The core holding of *3Com* thus is that director "decisions administering a stockholder approved Plan consistently with that Plan are entitled to the protection of the business judgment rule." Similarly, in *Weiss v. Swanson*,[11] the Court of Chancery stated that directors' grant of stock options to themselves pursuant to a stockholder-approved plan are entitled to business judgment deference as long as "the terms of the plan at issue are adhered to."

The *Slager* court distinguished *3Com* by finding that in *3Com*, business judgment deference applied to option awards because the stockholder-approved plan had "sufficiently defined terms" and "meaningful limits" on director discretion. *Slager* explained that "[t]he sufficiency of definition that anoints a stockholder-approved option or bonus plan with business judgment rule protection exists on a continuum." 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." Conversely, if a stockholder-approved plan permits the board "to use its absolute discretion…with little guidance as to the total pay that can be awarded, a board will ultimately have to show that the transaction is entirely fair."

In the *Slager* plan, the court perceived "no effective limits on the total amount of pay that can be awarded through time-vesting restricted stock units. The plan…confers on the Defendant Directors the theoretical ability to award themselves as much as tens of millions of dollars per year, with few limitations." Consequently, the court held that the directors were "interested in the decision to award themselves a substantial bonus" and must prove the amounts they awarded themselves were entirely fair.

Conclusion

Slager confirms the broad discretion afforded to most board decisions on executive compensation, but indicates that decisions made under a stockholder-approved equity compensation plan may receive business judgment deference only where the plan has sufficient definition and meaningful limits on director discretion to award themselves compensation. Striking a workable balance between reducing litigation risk by narrowing plan-authorized director discretion over equity awards, and ensuring the board has flexibility to respond to evolving internal and external conditions affecting director compensation requires careful consideration, and *Slager* provides good reason for boards and their advisers to review equity compensation plans.

Endnotes:

1. 2012 WL 2501105 (Del. Ch. June 29, 2012).

2. *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000).

3. *In re InfoUSA, Inc. S'holders Litig.*, 953 A.2d 963, 984 (Del. Ch. 2007),

4. *Sample v. Morgan*, 914 A.2d 647, 669 (Del. Ch. 2007).

5. *Steiner v. Meyerson*, 1995 WL 441999, at *1 (Del. Ch. July 19, 1995).

6. *In re 3Com Corp.*, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999).

7. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

8. *Criden v. Steinberg*, 2000 WL 354390 (Del. Ch. March 23, 2000).

9. 918 A.2d 341 (Del. Ch. 2007).

10. 1999 WL 1009210 (Del. Ch. Oct. 25, 1999).

11. 948 A.2d 433 (Del. Ch. 2008).

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