Delaware Chancery Court Refuses to Grant Business Judgment Deference to Director Equity Awards under Unbounded, Shareholder-Approved Equity Incentive Plan

In *Seinfeld v. Slager*, the Delaware Chancery Court gave a reduced level of deference to the Republic Services, Inc. board's decision to grant equity incentive awards to its own members under a shareholder-approved equity incentive plan. As a result, the court denied the defendants' motion to dismiss the award-related claims. The court emphasized that the plan placed no meaningful limits on the board's discretion to set and structure the awards, thus making the directors "interested in self-dealing transactions" and barring the application of the deferential business judgment rule to the board's decision to issue the awards. As a result of this decision, companies may want to revisit the terms of their director equity incentive plans with an eye towards including thoughtful, specific limitations on the board's discretion to issue awards to directors each year.

The Republic Services, Inc. directors enjoyed broad discretion under the terms of the stock incentive plan, subject only to a maximum of 10.5 million shares that could be issued under the plan and individual annual limits of no more than 2.5 million shares subject to stock options and stock appreciation rights, no more than 1.25 million shares subject to performance shares, restricted stock awards and common shares, and no more than $4 million in grant date value of performance units.

The actual awards fell well within these limits. The Republic Services board approved two annual tranches of restricted stock units to twelve of the thirteen defendant board members. The awards were valued at approximately $740,000 and $215,000, respectively, per member. The court noted that "[a]ssuming that there were 12 directors, the Board could theoretically award each director 875,000 restricted stock units. At $24.79, the award to each director would be worth $21,691,250 and the total value would be $260,295,000."

Even though the board's award fell well within the discretionary range approved by the shareholders, the court refused to evaluate the awards under the business judgment rule. The court stipulated that "there must be some *meaningful* limit imposed by the stockholders on the Board for the plan to…receive the blessing of the business judgment rule." Shareholder approval alone is insufficient where the plan amounts to a "*carte blanche*" devoid of any guidance as "to the *total* pay that can be awarded." In the absence of such meaningful limits, a board must show that the challenged transaction "is entirely fair."

In reaching this conclusion, the court distinguished the case of *In re 3COM Corp. Shareholders Litigation*, 1999 WL 1009210 (Del. Ch.). The *3COM* court extended the protection of the business judgment rule to directors who administer shareholder-approved stock incentive plans. So long as an award is not an egregiously disproportionate exchange for the director's services, the board members satisfy their duty of loyalty if they act in accordance with the terms of such a shareholder-approved plan.

As the *Seinfeld* court noted, however, *3COM* emphasized that the awards had accrued to the directors under a plan with well-defined terms and, therefore, that the directors had not "independently or unilaterally" granted themselves the incentive payments. The *3COM* plan placed specific (and moderately tight) limits on the number of shares that the board could issue, with the applicable limit determined by the type of service that the recipient had performed. Thus, a board member who served on a committee was subject to one limit, while a member who chaired the board was subject to another. In contrast, the Republic Services directors "enjoyed the theoretical ability to award themselves as much as tens of millions of dollars per year, with few

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limitations." In the *Seinfeld* court's view, *3COM* could not have contemplated a plan that confers such open-ended discretion.

The court offered simple advice to companies considering implementing a director equity incentive plan: "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." Thus, following *Seinfeld*, companies may want to revisit the terms of their director equity incentive plans with an eye towards including thoughtful, specific annual limitations on the board's discretion to issue awards to directors.

Please contact the Ropes & Gray attorney who usually advises you with any questions you may have or if you would like additional information.

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