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Seinfeld v. Slager: The Delaware Chancery Court's New Legal Standard for Reviewing Directors' Decisions About Their Own Pay

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I. INTRODUCTION

In the United States, corporate directors are authorized to set their own compensation.[1] Inherent in this authority is the incentive for directors to award themselves substantial bonuses.[2] When directors set their own compensation, they are self-interested because they stand on both sides of the transaction.[3] In general, director decisions are protected by the business judgment rule, which presumes that "directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best interest."[4] However, when director decisions involve self-dealing or self-interest, directors need shareholder ratification; otherwise, they have the burden to show that the transaction is entirely fair to the corporation.[5] Therefore, to ensure that director's decisions about their own compensation are provided the protection of the business judgment rule, corporations prefer to implement generic compensation plans that are submitted to shareholders for approval. Shareholder-ratified compensation plans generally set lax limitations and authorize directors to have broad discretion in deciding the compensation each director will earn each year.[6]

In the past few decades, having recognized that the incentive for directors to award themselves more than what they are entitled to is not eliminated by having a ratified compensation plan in place, Delaware courts[7] have limited the application of the business judgment rule even in cases involving shareholder-approved director

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1. This authority is derived from the Model Business Corporation Act, which has been adopted, at least in part, by most U.S. jurisdictions. *See* Model Bus. Corp. Act, at xix, § 8.11 (2005) ("Unless the articles of incorporation or bylaws provide otherwise, the board of directors may fix the compensation of directors.").

2. Seinfeld v. Slager, No. 6462-VCG, 2012 WL 2501105, at *12 (Del. Ch. June 29, 2012).

3. *See* Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 745–46 (Del. Ch. 2007).

4. Black's Law Dictionary 226–27 (9th ed. 2009).

5. *See* Ann M. Scarlett, *Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts' Response to Recent Corporate Scandals*, 60 Fla. L. Rev. 589, 607 (2008); Ravenswood Inv. Co. v. Winmill, No. 3730-VCN, 2011 WL 2176478, at *4 (Del. Ch. May 31, 2011).

6. *See, e.g.*, Republic Servs., Inc., Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Form 14A) (Apr. 6, 2007), *available at* http://www.sec.gov/Archives/edgar/data/1060391/000095014407003261/g06437def14a.htm#129 (authorizing directors to grant a total of 10.5 million shares in equity compensation, 2.5 million of which were subject to grants of options or stock appreciation rights, to any "eligible individual" during any fiscal year, and 1.25 million of which were subject to grants of performance shares, restricted stock, and awards of common stock to any "eligible individual" during any fiscal year).

7. Delaware courts are perceived as leaders in the development of corporate law and that is why Delaware law is the focus of this note. *See, e.g.*, *In re* Aguilar, 344 S.W.3d 41, 47 (Tex. App. 2011) (describing Delaware as "the Mother Court of corporate law"); Jerue v. Millett, 66 P.3d 736, 745 (Alaska 2003) (also describing Delaware as "the Mother Court of corporate law"); Wooley v. Lucksinger, 14 So. 3d 311, 474 (La. Ct. App. 2008) (acknowledging "Delaware's leadership in the field of corporate law"). The term "stockholder" adopted by Delaware courts will be used in this article interchangeably with the term "shareholder" adopted by some other jurisdictions.

compensation plans.[8] Ultimately, in June 2012, the Delaware Chancery Court decided *Seinfeld v. Slager* and adopted a higher standard for reviewing director compensation awards.[9]

Under this new standard, corporate directors have the burden to prove that the compensation they awarded to themselves is entirely fair to the corporation. Thus, these directors no longer enjoy the automatic blessing of the business judgment rule simply because shareholders ratified the company's compensation plan. Because the *Slager* standard has not been fully developed yet, it leaves Delaware corporations and their directors unclear about what safeguards would guarantee the protection of the business judgment rule. Furthermore, it leaves aggrieved shareholders bereft of guidance on which elements to plead in their complaints alleging excessive director compensation to satisfy this new standard, and thus survive directors' motions to dismiss.

This note discusses *Slager*'s heightened standard and attempts to clarify the ambiguities it presents to both corporate directors and shareholders. Part II presents the relevant background, and describes the evolution of director compensation practices. Part III discusses how the business judgment rule applies to director decisions in the context of self-dealing transactions, and how shareholder ratification can provide a "safe harbor" for conflicted directors. Part IV provides an overview of *Slager*'s new standard and suggests ways that corporate directors can ensure compliance with its requirements. Part V concludes this note.

II. HOW ARE DIRECTORS COMPENSATED?

A. A Brief History of Director Compensation

During the nineteenth and early twentieth centuries, corporate board members were not entitled to compensation for their services.[10] In *Cahall v. Lofland*, a leading Delaware decision of its time, the court held that "[d]irectors [were] presumed to serve without compensation[.]"[11] In *Lofland*, neither the charter nor the bylaws of the company authorized paying a salary or any other type of compensation to directors for their services.[12] The incentive to act in the best interests of the corporation stemmed from the directors' ownership of a substantial amount of the company's capital stock,

8. *See, e.g.*, *In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563 (Del. Ch. 2007) (denying protection of the business judgment rule in cases of "spring-loading" and "bullet-dodging"); Weiss v. Swanson, 948 A.2d 433 (Del. Ch. 2008) (same); Sample v. Morgan, 914 A.2d 647, 663 (Del. Ch. 2007) (internal quotations omitted) (stating that stockholder ratification is not a "blank check" theory and does not automatically guarantee the protection of the business judgment rule).

9. No. 6462-VCG, 2012 WL 2501105 (Del. Ch. June 29, 2012).

10. *See, e.g.*, Nat'l Loan & Inv. Co. v. Rockland Co., 94 F. 335, 337 (8th Cir. 1899) ("Directors of corporations . . . serve without wages or salary. They are generally financially interested in the success of the corporation they represent, and their service as directors secures its reward in the benefit which it confers upon the stock which they own."); Finch v. Warrior Cement Corp., 141 A. 54, 63 (Del. Ch. 1928) (requiring directors to surrender the profits they made as commissions back to the corporation).

11. 114 A. 224, 229 (Del. Ch. 1921).

12. *Id.* at 230.

which would produce dividends if the corporation performed well.[13] Plaintiffs argued that certain cash payments and stock issuances were made to the company's board members without consideration, and that these were received as compensation for extra services rendered to the company.[14] The Delaware Supreme Court concluded that directors could be compensated for services rendered within the scope of their duties as directors only if the company's stockholders, charter, or bylaws explicitly authorized such compensation.[15] Services outside their duties as directors could only be compensated where "an express contract to pay for such services" existed and if the contract was "made with directors, or other proper corporate officers who have no personal interest, directly or indirectly, in the contract[.]"[16]

The requirement to compensate independent directors eroded as the phenomenal growth of the American economy transformed corporate economics.[17] Corporations were no longer local ventures owned by entrepreneurs, but were instead national in size and scope.[18] They were no longer owned by a few, but rather by thousands of investors across the nation.[19] Former board members from the shareholder ranks were replaced by new members who were professional managers and typically owned only a very small portion of the company's shares.[20] These new outside directors owned little to no equity in the company and thus had no personal financial stake in rendering board service.[21] The need for director compensation arose because the only way to attract potential candidates—who did not have any equitable stake in the corporation's success, but were expected to expend time and effort in their roles as directors—was to incentivize them through compensation.[22]

In 1953, in response to this trend in director appointments, the Committee on Business Corporations of the American Bar Association revised the Model Business Corporation Act (the "Model Act") to authorize boards of directors to set their own compensation.[23] Importantly, the committee added the following sentence at the end of the Model Act, section 33: "The board of directors shall have the authority to fix

13. Lofland v. Cahall, 118 A. 1, 2 (Del. 1922).

14. *Id*.

15. *Id*.

16. *Id*. at 3.

17. Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. Rev. 127, 139–40 (1996).

18. *Id*.

19. *Id*.

20. *Id*.

21. *Id*. at 141.

22. *Id*.

23. The Model Act was created in 1950 to unify states' definitions of corporations. The initial 1950 version of the Act provided: "The business and affairs of a corporation shall be managed by a board of directors. Directors need not be residents of this State or stockholders of the corporation unless the articles of incorporation or by-laws so require. The articles of incorporation or by-laws may prescribe other qualifications for directors." Model Bus. Corp. Act § 33 (1950).

the compensation of directors *unless* otherwise provided in the articles of incorporation."[24] This language was adopted by most jurisdictions in their own versions of the statute[25] and remains practically intact in the current, slightly revised provision of the Model Act.[26] Like numerous jurisdictions, Delaware adopted its first version of the Model Act, section 33 in 1953.[27]

B. Current Trends in Director Compensation

By 1960, director compensation became generally accepted.[28] Presently, board members are compensated for their services to the corporation in various ways.[29] The traditional form of director compensation is a cash payment, such as an annual retainer or meeting fees.[30] Many corporations also compensate their directors on a deferred basis.[31] Outside directors, who are not otherwise employed by the corporation, may receive current or deferred compensation, or both.[32] To attract and

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24. Model Bus. Corp. Act § 33 (1953) (emphasis added).

25. Today, all but eight states have enacted statutes authorizing board members to set their own compensation. *See, e.g.*, Ala. Code § 10A-2-8.11 (2013); Ariz. Rev. Stat. Ann. § 10-811 (2013); Ark. Code Ann. § 4-27-811 (West 2013); Colo. Rev. Stat. Ann. § 7-108-111 (West 2013); D.C. Code § 29-306.11 (2013); Fla. Stat. Ann. § 607.08101 (West 2013); Ga. Code Ann. § 14-2-811 (West 2013); Haw. Rev. Stat. § 414-201 (West 2013); Idaho Code § 30-1-811 (West 2013); Ind. Code Ann. § 23-1-33-10 (West 2013); Iowa Code Ann. § 490.811 (West 2013); Kan. Stat. Ann. § 17-6301(h) (West 2013); La. Rev. Stat. Ann. §12:81(c) (2013); Mich. Comp. Laws Ann. § 450.1505(3) (West 2013); Minn. Stat. Ann. § 302A.211 (2013); Miss. Code Ann. Stat. § 79-4-8.11 (West 2013); Mo. Rev. Stat. § 351.310 (West 2013); Mont. Code Ann. § 35-1-427 (West 2013); Neb. Rev. Stat. Ann. § 21-2088 (West 2012); N.H. Rev. Stat. Ann. § 293-A:8.11 (2013).

26. *See* Model Bus. Corp. Act § 8.11 (1991) (stating in relevant part that "[u]nless the articles of incorporation or bylaws provide otherwise, the board of directors may fix the compensation of directors").

27. *See* Del. Code Ann. tit. 8, § 141(h) (West 2013).

28. In *Hall v. John S. Isaacs & Sons Farms, Inc.*, the Delaware Court of Chancery held that board members who were also salary recipients could establish entitlement to compensation for their services to the corporation, although unauthorized by a proper board and not validly ratified by independent stockholders. 146 A.2d 602, 612 (Del. Ch. 1958).

> In 1962, a substantial majority of the largest American public corporations compensated their outside directors. Among manufacturing companies, the median board meeting fee was $200, and the median annual retainer was $2000. By 1975, virtually all public companies compensated their directors and, among manufacturing companies, the median annual compensation, including fees and retainers, had grown to $6000, with the largest companies paying a median of $13,000.

Elson, *supra* note 17, at 147.

29. *See* 2 Michael B. Snyder, Compensation and Benefits § 9:24 (2013) [hereinafter Snyder, Compensation and Benefits].

30. *See* Robert A.G. Monks & Nell Minow, Corporate Governance 258–59 (5th ed. 2011).

31. Michael B. Snyder, Benefits Guide § 9:10 (2002) [hereinafter Snyder, Benefits Guide].

32. *Id.*

retain outside directors, many corporations allow them to participate in the company's deferred compensation plans,[33] which include retirement plans[34] and stock plans.[35]

Stock plans typically provide outside directors with grants of stock itself, options to purchase stock, or stock appreciation rights.[36] Granting stock outright is the simplest form of equity compensation because directors immediately become stockholders.[37] Granting an option to purchase stock allows directors to buy a specified number of shares at a price equal to the share price on the date the option is granted, known as the "exercise price" or "strike price."[38] Stock options are usually subject to a vesting schedule, which encourages a director to make a long-term commitment to stockholder interests by requiring continued board service before vesting.[39] Finally, stock appreciation rights, also referred to as "phantom stock" awards, provide directors with cash or stock payments based on the increase in the value of a stated number of shares over a specific period of time.[40]

In the past, courts have relied on the business judgment rule to protect directors' ability to pay themselves salaries and assign themselves stock awards upon shareholder approval.[41] Partly due to this safeguard provided by the courts, non-employee director compensation is rising significantly across all corporate revenue sectors.[42] The Dodd-Frank Wall Street Reform and Consumer Protection Act[43] slowed, but did not stop, the

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33. *Id*.

34. *See generally* Terri R. Day, *Pension Funds in Bankruptcy: The Spendthrift Trust "Safe Harbor"*, 43 Fla. L. Rev. 67, 91 (1991). Retirement plans cover employees' retirement or death benefits and are beyond the scope of this note, which will focus exclusively on stock compensation plans.

35. Snyder, Benefits Guide, *supra* note 31.

36. Andrew Stumpff, Employee Benefits and Executive Compensation 318 (2011).

37. Snyder, Compensation and Benefits, *supra* note 29.

38. Stumpff, *supra* note 36, at 319.

39. *Id.*

40. *Id.*

41. *See, e.g.*, *In re* CNET Networks, Inc., 483 F. Supp. 2d 947 (N.D. Cal. 2007) (dismissing a complaint arising out of multimillion dollar awards of backdated stock options to the company's board members); Seidman v. Clifton Savs. Bank, S.L.A., 205 N.J. 150, 155 (2011) (dismissing a complaint arising out of the payment of millions of dollars in salary, stock option grants, and restricted stock awards to seven board members). *See generally In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

42. According to data compiled by Bloomberg.com, board members' pay grew by a total of 15% between 2007 and 2012, the pay for directors at Standard & Poor's 500 Index companies rose to a record average of $251,000 and this is typically for only around 250–300 work hours a year. Jeff Green & Hideki Suzuki, *Board Director Pay Hits Record $251,000 for 250 Hours*, Bloomberg (May 30, 2013, 12:01 AM), http://www.bloomberg.com/news/2013-05-30/board-director-pay-hits-record-251-000-for-250-hours.html; *see also* Nat'l Ass'n of Corporate Dirs., The 2011–2012 NACD Director Compensation Report (2011–12), *available at* http://www.nacdonline.org/Resources/BoardVisionEpisode.cfm?ItemNumber=4778.

43. 12 U.S.C. § 5301 (2012).

growth of directors' compensation.[44] In 2012, the total median compensation paid to a director of a corporation with a market capitalization below $1 billion was $118,000, of a corporation with a market capitalization between $1 and $5 billion—$178,000, and of a corporation with a market capitalization above $5 billion—$229,000.[45]

Because *Slager* limited the protection of the business judgment rule previously afforded to directors deciding their own compensation, it makes challenging these decisions easier and potentially exposes directors to the risk of additional derivative lawsuits.[46] This is especially true considering the continuous rise in directors' compensation. Thus, now more than ever, corporate directors need guidance about how to ensure the protection of the business judgment rule and about what defenses pled in their answers will make the dismissal of disapproving shareholders' complaints more likely.

III. THE LIMITLESS PROTECTION OF THE PRE-*SLAGER* BUSINESS JUDGMENT RULE

The historical protection of the business judgment rule allows directors to manage a corporation without fear of having their decisions second-guessed by stockholders who have the benefit of hindsight.[47] The business judgment rule creates a rebuttable presumption that corporate directors make their business decisions with the company's best interests in mind.[48] When the requirements of the business judgment rule are satisfied, a director will not be liable for the consequences of his or her actions.[49] As a result, the business judgment rule gives directors the opportunity to take calculated risks without the threat of a lawsuit.[50] Procedurally, when board members exercise their business judgment, the plaintiffs challenging the transaction have the burden to rebut the presumption by disproving that the directors acted in the best interests of the corporation.[51] If the business judgment rule is not rebutted, a

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44. Frederic W. Cook & Co., Inc., 2012 Director Compensation Report: Non-Employee Director Compensation Across Industries and Size 1 (2012), *available at* http://www.fwcook.com/alert_letters/2012_Directors_Compensation_Report_Non-Employee_Director_Compensation_Across_Industries_and_Size.pdf.

45. *Id*.

46. *See generally* Advisen Ltd., D&O Claims Trends: Q1 2013, at 2 (April 2013), *available at* http://corner.advisen.com/pdf_files/QuarterlyD&O_ClaimsTrends_2013Q1.pdf (referring to a "surge" in say-on-pay claims filed by plaintiff's class action firms).

47. Scarlett, *supra* note 5, at 600.

48. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

49. Melvin Aron Eisenberg & James D. Cox, Corporations and Other Business Organizations Cases and Materials 282–83 (10th ed. 2011); Dennis J. Block, Stephen A. Radin & Nancy E. Barton, The Business Judgment Rule: Fiduciary Duties of Corporate Directors 5–6 (6th ed. 2009).

50. *See* Eisenberg & Cox, *supra* note 49, at 282–83; Block et al., *supra* note 49, at 5–6.

51. Block et al., *supra* note 49, at 5.

"court will not substitute its judgment for that of the board" because directors, and not the courts, are better suited to make business decisions.[52]

Furthermore, a showing of fraud, illegality, waste, or breach of fiduciary duties can rebut the presumption of business judgment.[53] Once a plaintiff rebuts the presumption by showing either that the directors violated a fiduciary duty or that the business judgment rule does not apply because defendants committed an act of fraud, illegality, or waste, the burden shifts back to the director-defendants to prove the "entire fairness" of the transaction.[54]

A. The Business Judgment Rule and Self-Dealing Transactions

There is an exception to the general application of the business judgment rule: it does not apply to self-dealing transactions. The duty of loyalty, which Delaware courts define as "the duty to act in good faith and in the company's best interest,"[55] dictates that the protection of the business judgment rule "can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment."[56] It requires directors to act "in the best interests of the company" and its stockholders instead of in their personal interests.[57]

A self-dealing transaction exists when an interested director stands on both sides of a transaction.[58] "A well settled precept of Delaware corporate law is that a fiduciary is considered interested where he or she will receive a personal financial benefit from the transaction that is not equally shared by the stockholders."[59] Director decisions regarding their own compensation necessarily involve self-dealing because a director who receives the benefit of corporate assets, stands on both sides of the transaction.[60] Therefore, unlike corporate executive compensation, which generally falls within the board's business judgment, director compensation—a self-dealing transaction—does

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52. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995) (quoting Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)).

53. Scarlett, *supra* note 5, at 601–02.

54. *Id.* at 602.

55. *In re* Gaylord Container Corp. S'holders Litig., 753 A.2d 462, 475 n.41 (Del. Ch. 2000) (citations omitted).

56. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). The court further stated that the business judgment rule prevents directors from being on both sides of the transaction or expecting any "financial benefit from it in the sense of self dealing[.]" *Id*.

57. *Id*.

58. *In re* LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 174–76, 175 n.36 (Del. Ch. 2005).

59. *Id*. at 175.

60. *See generally* David A. Drexler, Lewis S. Black Jr. & A. Gilchrist Sparks III, Delaware Corporation Law and Practice § 15.09 (2012); Wilderman v. Wilderman, 315 A.2d 610, 615 (Del. Ch. 1974).

not. As a result, the board members would bear the burden of proving that the salary and bonuses they pay themselves are entirely fair to the company.[61]

The entire fairness standard requires a court to analyze a challenged transaction for fair dealing.[62] This standard of review is most favorable to plaintiffs and requires defendants to prove, subject to strict judicial scrutiny, that the challenged transaction was objectively fair.[63] When courts require directors to pass the entire fairness test, directors must show a reasonable purpose for their actions.[64] Generally, a legitimate business purpose—for instance, employee retention or reducing transaction costs—would meet the fairness requirement and would pass the entire fairness test even when the challenged transaction negatively affects stockholders.[65] The entire fairness test does not, however, require directors to show that their action is the result of their best effort to fulfill the interests of the challenging minority; rather, it requires them to prove that their action is plausible or reasonable.[66]

Nevertheless, there are ways directors can avoid having to meet the entire fairness standard in the context of self-dealing transactions. Specifically, there are two ways to eliminate the conflict and establish business judgment rule protection for board members who made decisions about their own compensation: (1) using an independent compensation committee to design a compensation plan and (2) submitting the plan to stockholders for ratification.[67]

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61. *See* Ravenswood Inv. Co. v. Winmill, No. 3730-VCN, 2011 WL 2176478, at *1, *4 (Del. Ch. May 31, 2011) ("[W]here the individuals comprising the board and the company's management are the same, the board bears the burden of proving that the salary and bonuses they pay themselves as officers are entirely fair."); *see also* Kahn v. Tremont Corp., 694 A.2d 422, 431 (Del. 1997) (stating that the entire fairness monitor "ensure[s] that individuals who purport to act as fiduciaries in the face of conflicting loyalties exercise their authority in light of what is best for all entities"); Garza v. TV Answer, Inc., No. 12784, 1993 Del. Ch. LEXIS 40, at *16–18 (Del. Ch. Mar. 15, 1993) (denying director-defendants' motion to dismiss because the business judgment rule would be unavailable if alleged self-enrichment of defendants was proven); Wilderman v. Wilderman, 315 A.2d 610, 615 (Del. Ch. 1974) (holding that because the defendant fixed his own salary, he was required to prove that the salary was entirely fair—a burden that the defendant was unable to meet); Marx v. Akers, 88 N.Y.2d 189, 204 n.6 (1996). In transactions where directors approve their own compensation, as in any other conflict of interest transaction, directors bear "the burden of proving that the transaction was fair to the corporation[.]" *Id.*

62. Lewis H. Lazarus & Brett M. McCartney, *Standards of Review in Conflict Transactions on Motions to Dismiss: Lessons Learned in the Past Decade*, 36 Del. J. Corp. L. 967, 974 (2011).

63. Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

64. Nicola de Luca, *Unequal Treatment and Shareholders' Welfare Growth "Fairness" v. "Precise Equality"*, 34 Del. J. Corp. L. 853, 858 (2009).

65. *See, e.g.*, Nixon v. Blackwell, 626 A.2d 1366 (Del. 1993) (finding that creating an "employees only" stock option plan for the purpose of employee retention met the fairness requirement and passed the entire fairness test); Applebaum v. Avaya, Inc., 805 A.2d 209 (Del. Ch. 2002) (justifying a reverse stock split in order to reduce costs).

66. *See* Lazarus & McCartney, *supra* note 62, at 974.

67. Ravenswood Inv. Co. v. Winmill, No. 3730-VCN, 2011 WL 2176478, at *4 (Del. Ch. May 31, 2011).

B. *The Effect of Stockholder Ratification on Self-Dealing Transactions*

Ratification derives from the law of agency, which establishes the legal authority of an agent in circumstances where the agent is not given express authority by the principal.[68] Ratification is effective only if the agent completely discloses all relevant information related to the transaction to the principal.[69] Because the relationship between the agent and the principal is fiduciary in nature, the agent seeking ratification must act with candor and loyalty.[70] Thus, if the principal's consent is obtained through coercion, the ratification will be invalid.[71]

Assuming ratification sought by an agent is validly obtained, what effect does it have under corporate law if board members are the agents and stockholders are the principals? The Delaware Supreme Court has suggested that in instances other than those when a stockholder vote is a necessary step in authorizing a transaction,[72] there are four possible effects of stockholder approval of a transaction.[73] First, ratification can be treated as a complete defense to any charge of a breach of a fiduciary duty.[74] Second, ratification can change the standard of judicial review from the entire fairness to the waste standard of review.[75] Third, ratification can shift the burden of persuasion back to the plaintiff to prove the unfairness of a self-dealing transaction.[76] Finally, ratification can be treated as undeserving of judicial recognition because of stockholder apathy, discrepancies in the definition of a "disinterested" stockholder, or because a disinterested stockholder decision to approve a transaction was influenced by interested directors, managers, or stockholders.[77]

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68. Restatement (Second) of Agency § 82 (1958).

69. *Id.* § 91.

70. Lewis v. Vogelstein, 699 A.2d 327, 334 (Del. Ch. 1997). For a more detailed discussion of the "duty of candor" see *infra* Part III.B.2.

71. *Lewis*, 699 A.2d at 334; Restatement (Second) of Agency § 100.

72. The doctrine of ratification "must be limited to its so-called 'classic' form; that is, to circumstances where a fully informed shareholder vote approves director action that does *not* legally require shareholder approval in order to become legally effective." Gantler v. Stephens, 965 A.2d 695, 713 (Del. 2009). Therefore, the doctrine of ratification would apply in circumstances of approval of a compensation plan, but will be inapplicable, for instance, to an amendment of a certificate of incorporation, approval of a merger, or dissolution of an enterprise.

73. *Lewis*, 699 A.2d at 334.

74. *See, e.g.*, *In re* Wheelabrator Techs., Inc. S'holders Litig., 663 A.2d 1194 (Del. Ch. 1995) (holding that ratification eliminates any claim for breach of duty of care); Sample v. Morgan, 914 A.2d 647, 663 (Del. Ch. 2007) (noting that uncoerced, fully informed, and disinterested stockholder approval of a corporate action, in most situations, precludes claims for breach of fiduciary duty challenging that action).

75. *See, e.g.*, Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979) (noting that effective ratification of a director-interested transaction triggers application of the waste standard).

76. *See, e.g.*, Citron v. E.I. du Pont de Nemours & Co., 584 A.2d 490, 500 (Del. Ch. 1990) (noting that effective ratification shifts the burden of persuasion to plaintiff).

77. *Lewis*, 699 A.2d at 334; *see also* J. Robert Brown, Jr., *Speaking with Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty*, 54 Hastings L.J. 642 (2003) (recognizing that the number of disinterested stockholders who approve the transaction can be miscalculated as a result of

Most frequently, courts hold that disinterested stockholder approval reinstates the business judgment rule and precludes judicial scrutiny of the transaction.[78] In Delaware, this outcome derives from the Delaware Corporate Code, section 144(a)(2), which states that no transaction involving a conflicted director will be invalidated if "[t]he material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the stockholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholders[.]"[79] Therefore, Delaware courts have traditionally treated fully informed stockholder ratification as validation of a self-dealing transaction and have removed these transactions from the purview of the entire fairness review.[80]

Notwithstanding stockholder ratification, a plaintiff can challenge director compensation in three ways: by establishing (1) that ratification was obtained through coercion,[81] (2) that the challenged transaction constituted waste of corporate assets, or (3) that ratification was based on incomplete disclosure.[82] Until *Slager*, in cases where stockholders had approved compensation plans authorizing director compensation, these were the only avenues available to stockholder-plaintiffs seeking to challenge excessive compensation awarded by directors to themselves.[83]

1. Challenging Director Compensation Post-Ratification on the Grounds of Waste

Even though stockholder ratification might protect the board against suits claiming it violated its fiduciary duty of loyalty or care, it does not protect the board

the following factors: (1) Delaware courts have not defined the term "disinterested" stockholder and as a result, management has considerable discretion in determining which votes count, (2) management has no express obligation to implement a system designed to ensure that interested shares are not counted in the final total, and (3) stockholder identity can be obscured through nominee accounts and other forms of beneficial ownership).

78. *See, e.g.*, *Lewis*, 699 A.2d at 336; *In re Wheelabrator*, 663 A.2d at 1203; *see also In re* 3COM Corp. S'holders Litig., No. C.A. 16721, 1999 WL 1009210, at *1 (Del. Ch. Oct. 25, 1999) (holding that prior stockholder approval of a stock option plan reinstates the business judgment rule); *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 367–69 (Del. Ch. 1998), *aff'd in part, rev'd in part on other grounds and remanded*, 746 A.2d 244 (Del. 2000).

79. Del. Code Ann. tit. 8, § 144 (West 2013).

80. *In re Walt Disney Co.*, 731 A.2d at 368.

81. An otherwise valid stockholder vote may be nullified by a showing that the structure or circumstances of the vote were impermissibly coercive. Williams v. Geier, 671 A.2d 1368, 1382 (Del. 1996); *see also In re* Gen. Motors Class H S'holders Litig., 734 A.2d 611, 620 (Del. Ch. 1999) ("Impermissible coercion exists where the 'board . . . takes actions which [influence] the stockholders to vote in favor of the proposed transaction for some reason other than the merits of the transaction.'") (quoting *Williams*, 671 A.2d at 1382–83). Even though coercion is a valid ground for invalidating shareholders' approval of a transaction, it is rarely used in cases challenging executive or director compensation, and is therefore not addressed in this note.

82. *See, e.g.*, Sample v. Morgan, 914 A.2d 647, 652 (Del. Ch. 2007) (denying defendants' motion to dismiss the complaint based on allegations that stockholder ratification was procured through materially misleading disclosures).

83. *See, e.g.*, *Lewis*, 699 A.2d at 339 (holding that stockholders had a sufficient claim for waste despite proper stockholder ratification of the company's stock option and compensation plan).

against claims of waste of corporate assets.[84] Acts of corporate waste cannot be corrected by a non-unanimous majority vote because such acts are void, i.e. "*ultra vires*, fraudulent gifts or waste of corporate assets," rather than voidable, i.e. acts that could be "performed in the interest of the corporation but beyond the authority of management."[85] While voidable acts can usually be cured by non-unanimous majority stockholder ratification, void acts cannot.[86] A void act "serves as an exception to the defense of shareholder ratification and can be cured only by a unanimous shareholder vote."[87] Therefore, even if the compensation plan was ratified by the stockholders, a stockholder may still bring a derivative action and survive a motion to dismiss if waste is properly alleged.[88]

The standard for claiming waste is high and "very rarely satisfied by a shareholder-plaintiff."[89] To state a claim for waste, a plaintiff must show that the challenged transaction is "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[90] Most often, the claim is associated with "a transfer of corporate assets that serves no corporate purpose" or "for which no consideration at all is received."[91] However, if the directors acted in good faith in approving the transaction and there was any substantial consideration received by the corporation, there will be no finding of waste, even if "the fact finder would conclude *ex post* that the transaction was unreasonably risky."[92] Under this standard, the court is not expected to examine "the allegations to see whether consideration, once received, was excessive or lopsided, was proportional or not, or even whether it was a 'bad deal' from a business standpoint." [93] In other words, the court is not expected to exercise business judgment because that authority is reserved for the boards.[94]

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84. Eric L. Johnson, *Waste Not, Want Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste*, 26 J. Corp. L. 145, 154 (2000).

85. *Id*.; Michelson v. Duncan, 407 A.2d 211, 218-19 (Del. 1979).

86. *Michelson*, 407 A.2d at 218–19 ("The essential distinction between voidable and void acts is that the former are those which may be found to have been performed in the interest of the corporation but beyond the authority of management, as distinguished from acts which are [u]ltra vires, fraudulent or gifts or waste of corporate assets.").

87. Mary A. Jacobson, *Interested Director Transactions and the (Equivocal) Effects of Shareholder Ratification*, 21 Del. J. Corp. L. 981, 992 (1996).

88. *See* Johnson, *supra* note 84, at 153–55.

89. *In re* 3COM Corp. S'holders Litig., No. C.A. 16721, 1999 WL 1009210, at *4 (Del. Ch. Oct. 25, 1999).

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

91. Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997).

92. *Id*.; *see also In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006) (justifying hiring a president who was subsequently terminated less than a year later at a cost of $130 million in severance payout).

93. *In re 3COM Corp.*, 1999 WL 1009210, at *4 (internal quotation marks omitted).

94. *Id.*

Courts generally give great deference to board decisions concerning director and executive compensation because the board is in the best position to determine if a particular individual warrants large sums of money, and whether the compensation should be paid in the form of a salary, a retainer, or on a deferred basis.[95] Deference is given to encourage boards to undertake the optimal and rational level of risk.[96] Moreover, courts are "ill-fitted to attempt to weigh the 'adequacy' of consideration . . . or . . . to judge appropriate degrees of business risk."[97]

Courts cannot declare director or executive compensation excessive without immediately inviting the question: "How much is too much?"[98] This question can be answered only through factual investigations which cover, *inter alia*, the "acumen of the [employee], the competitive environment in the industry, and the recruitment and retention challenges faced by the corporation."[99] Therefore, the question of "how much is too much?" is "far better suited for the boardroom than the courtroom" because board members have a better grasp of these relevant facts.[100]

Based on these principles, stockholder complaints alleging that director compensation constituted waste are commonly dismissed.[101] For a stockholder-plaintiff to succeed on a claim of waste in the context of director or executive compensation, the directors' actions must be extreme. For instance, in *In re Citigroup Inc. Shareholder Derivative Litigation*, the Delaware Chancery Court stated that the departure package for the former CEO—which included $68 million in salary, bonus, and accumulated stockholdings, plus an administrative assistant, and a car with a driver for up to five years—could create, if proven, a reasonable doubt that the agreement was "so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[102]

In another example, *Sample v. Morgan*, a shareholder brought a derivative class action after corporate directors issued shares to allegedly "attract and retain" key employees.[103] The Delaware Chancery Court declined to dismiss plaintiff's claim for waste because the inside directors authorized issuing 200,000 shares to themselves for only $200, or one cent per share, all the while knowing that the shares had a per-share

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95. *Brehm*, 746 A.2d at 263.

96. *Lewis*, 699 A.2d at 336.

97. *Id.*

98. *In re* InfoUSA, Inc. S'holders Litig., 953 A.2d 963, 983 (Del. Ch. 2007).

99. *Id.*

100. *Id.*

101. *See, e.g.*, Steiner v. Meyerson, Civ. A. No. 13139, 1995 WL 441999, at *1 (Del. Ch. July 19, 1995) (granting motions to dismiss stockholder claims that options grants constituted actionable waste); Zupnick v. Goizueta, 698 A.2d 384 (Del. 1997) (same); *In re* 3COM Corp. S'holders Litig., No. C.A. 16721, 1999 WL 1009210, at *4, *8 (Del. Ch. Oct. 25, 1999) (same).

102. 964 A.2d 106, 137 (internal quotation marks omitted).

103. 914 A.2d 674, 650 (Del. Ch. 2007).

value of at least $5.60.[104] The directors then authorized the company to borrow approximately $700,000 to cover the taxes owed by the inside directors on the shares they received, the sum of which constituted 8.4% of the company's annual net proceeds.[105] The court held that a tax-free grant of nearly a third of the company's voting power and dividend stream to existing managers in exchange for one-tenth of a penny per share raised a pleading-stage inference of waste.[106]

Similarly, in *Telxon Corp. v. Bogomolny*, the Delaware Chancery Court held that the plaintiff sufficiently stated a claim of waste when the corporation awarded its chairman the right to acquire 10% of the fully diluted equity of a valuable, wholly owned subsidiary of the corporation and required the corporation to finance the chairman's exercise of that option on a non-recourse basis.[107] The chairman was given an option to purchase the subsidiary's stock at $1.86 per share, while these same shares were worth eleven dollars merely two years later when the subsidiary went public.[108]

2. *Challenging Director Compensation for Failure to Disclose Material Information*

Another way for a stockholder-plaintiff to eliminate the protection of the business judgment rule given to a ratified director decision is to successfully allege that the proxy statement[109] soliciting stockholder approval of the compensation plan was misleading or omitted material information.[110] These allegations, if proven, render ratification ineffective and shift the burden to the directors to disprove a breach of the duty of disclosure.[111] To access the ratification safe harbor, directors must meet "an affirmative 'burden of demonstrating full and fair disclosure.'"[112] The burden is met by showing that even after reviewing a complaint in the light most favorable to the plaintiff, it does not contain facts supporting an inference that the directors failed to disclose a material fact or otherwise mislead stockholders.[113]

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104. *Id*. at 650–51.

105. *Id*. at 651.

106. *Id*. at 652–53.

107. 792 A.2d 964, 967–68 (Del. Ch. 2001).

108. *Id.* at 969–70.

109. A proxy statement is a document that shareholders are entitled to receive prior to a shareholder meeting of a company whose securities are registered under section 12 of the Securities Exchange Act of 1934. This document must contain all the important facts about issues on which shareholders are asked to vote on, so that they can make informed decisions about matters that will be brought up at an annual stockholder meeting. *See Proxy Statement*, U.S. Sec. & Exch. Comm'n, http://www.sec.gov/answers/proxy.htm (last visited Feb. 11, 2014).

110. *See, e.g.*, Noerr v. Greenwood, No. C.A. 14320, 1997 WL 419633, at *10 (Del. Ch. July 16, 1997) (noting that the burden to prove the entire fairness of certain compensation plans shifted to defendants upon plaintiff's showing of inadequate disclosures in the proxy statements seeking shareholders' approval of said plans).

111. *See id*. at *3.

112. Sample v. Morgan, 914 A.2d 647, 665 (Del. Ch. 2007) (quoting Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 140–41 (Del. 1997)).

113. *Id*.

The fiduciary duty of disclosure, used interchangeably with the "duty of complete candor,"[114] requires directors to disclose all material information within their control when they seek shareholder action.[115] By ensuring adequate disclosure, the fiduciary duty of complete candor prohibits "misleading partial disclosures"[116] and, in some cases, "literally true statements" if materially incomplete.[117] For the most part, Delaware courts have followed the federal definition of materiality, holding the two standards comparable.[118] Thus, as under Securities and Exchange Commission Rule 10b-5,[119] information is material under Delaware law if there is a "substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder."[120] Furthermore, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[121] Delaware courts have noted that materiality is a mixed question of law, because it involves information mandated by statute and facts,[122] and it should be answered from the perspective of stockholders, not directors.[123]

However, Delaware courts do not require disclosure of *all* relevant information. To determine what qualifies as adequate disclosure, courts balance the benefits of disclosure against the harms of inundating stockholders with unnecessary information.[124] This materiality test ensures that disclosures are not so broad as to bury "shareholders in an avalanche of trivial information" or otherwise cause investor confusion.[125] "The theory goes that there is a risk of information overload such that shareholders' interests are best served by an economy of words rather than an overflow of adjectives and adverbs in solicitation statements."[126]

114. Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 Vand. L. Rev. 1087, 1097–98 (1996).

115. *Id*. at 1090–91 (citing Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992)).

116. *See* Weiss v. Samsonite Corp., 741 A.2d 366, 374 n.19 (Del. Ch. 1999).

117. *See* Sonet v. Plum Creek Timber Co., No. 16931, 1999 WL 160174, at *7 (Del. Ch. Mar. 18, 1999).

118. *See* Brown, Jr., *supra* note 77, at 669.

119. Rule 10b-5 prohibits the use of false or misleading statements or omissions that result in fraud or deceit in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b-5 (2013).

120. TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976).

121. *Id*.

122. Zirn v. VLI Corp., 621 A.2d 773, 779 (Del. 1993).

123. *Id*. ("[T]he focus is on what a reasonable investor would consider important in tendering his stock, not what a director considers important.").

124. *See* Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1280–81 (Del. 1994); *see also* Solomon v. Armstrong, 747 A.2d 1098, 1128 (Del. Ch. 1999) ("The determination of the materiality of an alleged omission or misstatement 'requires a careful balancing of the potential benefits of disclosure against the resultant harm.'" (quoting *Arnold*, 650 A.2d at 1279)).

125. *TSC Indus.*, 426 U.S. at 449.

126. *Solomon*, 747 A.2d at 1128.

In the specific context of compensation plan ratification, Delaware courts hold that the duty of disclosure is satisfied by disclosing a "fair summary of all of the relevant terms and conditions of the proposed plan of compensation, together with any material extrinsic fact within the board's knowledge bearing on the issue."[127] Delaware court decisions also offer guidance on which nondisclosures will disqualify the ratification of a compensation plan.

In *Sample*, stockholders brought a derivative waste claim arising out of purportedly unlawful enrichment of the board members by alleging, *inter alia*, that stockholder ratification of the company's stock incentive plan was procured through materially misleading disclosures.[128] The Delaware Chancery Court articulated the rule for sustaining a complaint for a breach of the fiduciary duty of disclosure within the context of director compensation.[129] The court held that to survive a motion to dismiss, a complaint must plead that a material fact relevant to the voting decision had not been disclosed, or that the directors had failed to provide a full and fair explanation of the rationale for the proposal.[130] Under *Sample*, information regarding a compensation plan is "material" if a reasonable investor would consider it relevant in making his decision on whether to cast his vote for or against the plan.[131] There, the following omitted facts were held to be material: (1) all of the shares authorized by the stockholders would be granted to the "insider majority," and (2) the shares authorized by the incentive plan would be the only shares the company could issue in the upcoming five years.[132] Furthermore, the court opined that the omission of the true rationale for the plan—issuing 200,000 shares to the insider majority instead of attracting and retaining key employees—was detrimental to the stockholder ratification, rendering it ineffective.[133] The *Sample* court concluded that because stockholder approval was obtained through materially defective disclosures, the defendants' motion to dismiss should be denied.

In *In re Tyson Foods Inc. Consolidated Shareholder Litigation*, another stockholder derivative action alleging breach of fiduciary duties within the context of director compensation, the Delaware Chancery Court held that the validity of stockholder ratification required the "full, unvarnished truth" in a proxy statement seeking stockholder approval of a plan authorizing stock grants to the company's directors.[134] The court further held that when a plan authorizes "spring-loading" or "bullet-

127. Lewis v. Vogelstein, 699 A.2d 327, 333 (Del. Ch. 1997).

128. 914 A.2d 647 (Del. Ch. 2007).

129. *Id*. at 665.

130. *Id*.

131. *Id*. at 664 n.55.

132. *Id*. at 666.

133. *Id*. at 666–67.

134. No. C.A. 1106-CC, 2007 WL 2351071, at *4 n.18 (Del. Ch. Aug. 15, 2007).

dodging,"[135] this information should be expressly disclosed in the proxy.[136] Because the proxy lacked explicit statements that the plan authorized directors to make these challenged, "improbably fortuitous" stock awards, it rendered the stockholder ratification ineffective and thus eliminated the protection of the business judgment rule.[137]

Notably in *Tyson*, in addition to clarifying what constitutes a disclosure of "material information," the court narrowed the application of the business judgment rule by carving out an exception in cases where "spring-loading" or "bullet-dodging" is alleged.[138] The *Tyson* court held that a claim against a plan authorizing "spring-loading" or "bullet-dodging" will rebut the business judgment rule if a plaintiff can establish that: (1) the challenged grants were given pursuant to an options plan, (2) the directors who approved the grants possessed material non-public information soon to be released that would affect the company's share price, and (3) those directors issued the options with the intent to circumvent otherwise valid stockholder-approved restrictions upon the exercise price of the options.[139]

Even though the *Tyson* court narrowed the safe harbor of the business judgment rule, its holding is limited to the very specific circumstances of "spring-loading" or "bullet-dodging." Outside these unique circumstances, a dissatisfied stockholder is still limited to claims of waste or defective disclosures when challenging excessive compensation awards made to the company's board post ratification. Only upon having successfully alleged either waste or invalid ratification would the burden shift to the defendants to prove the entire fairness of the compensation award. This was the state of affairs before *Seinfeld v. Slager*.

IV. *SLAGER* AND ITS RESTRICTION OF THE BUSINESS JUDGMENT SAFE HARBOR

As in *Tyson*, in *Sample*'s dicta, the Delaware Chancery Court opined that the protection granted to ratified director actions should be further limited in the context of director compensation.[140] The court noted that ratification is not a "blank check" theory, and therefore properly ratified corporate actions can still be challenged if directors breach a fiduciary duty.[141] In this context, balancing law and equity is "an

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135. "Spring-loading" is defined as granting options just before the quarterly earnings release; "bullet-dodging" is defined as delaying granting options until after the release of quarterly earnings containing materially adverse information. Both "spring-loading" and "bullet-dodging" increase the value of the option grants, causing the company to receive too little money when the options are eventually exercised. *See* Justin Fox, *Which Options Sins Are Committed Most?*, Time (Nov. 14, 2006), http://business.time.com/2006/11/14/which_options_sins_are_committ/#ixzz2EKRzbdt3.

136. *See In re Tyson Foods*, 2007 WL 2351071.

137. *Id.* at *4; *see also* Weiss v. Swanson, 948 A.2d 433, 446–47 (Del. Ch. 2008) (providing similar reasoning).

138. *In re* Tyson Foods, Inc., 919 A.2d 563, 593 (Del. Ch. 2007).

139. *Id.*

140. Sample v. Morgan, 914 A.2d 647, 663–64 (Del. Ch. 2007).

141. *Id.* at 663–64.

essential aspect" of American corporate law.[142] As a result, "[s]tockholders can entrust directors with broad legal authority precisely because they know that that authority must be exercised consistently with equitable principles of fiduciary duty."[143] But, the court did not apply these equitable principles in *Sample*; instead, the court discredited ratification due to inadequate disclosures and on this ground denied the defendants' motion to dismiss. However, these equitable principles were fully developed in *Slager*, giving rise to a new standard for reviewing director compensation decisions following proper ratification.

In *Slager*, the plaintiff, a stockholder of Republic Services, Inc., claimed, *inter alia*, that directors breached their duty of loyalty and wasted corporate assets by awarding themselves certain stock options.[144] The plaintiff asserted that the board had overpaid its members by awarding them too many time-vested, restricted stock units in 2009 and 2010.[145] Under Republic's Stock Incentive Plan, which had been approved by the company's stockholders, the directors were authorized to award a total of 10.5 million shares, 2.5 million of which were subject to grants of options or stock appreciation rights, to any "eligible individual" during any fiscal year, and 1.25 million of which were subject to grants of performance shares, restricted stock, and awards of common stock to any "eligible individual" during any fiscal year.[146] Furthermore, the plan gave the directors "sole and absolute discretion" to grant restricted stock units in those amounts and on those terms as they deemed appropriate.[147]

In 2009, the director-defendants awarded themselves, as "eligible" participants in the plan, $743,700 per member in restricted stock units. As a result, the directors' annual individual compensation ranged from $843,000 to $891,000.[148] In 2010, the board awarded each director $215,000 in restricted stock units, such that the directors' individual annual compensation ranged from $320,000 to $345,000.[149] The plaintiff alleged that the directors' compensation far exceeded the compensation paid by Republic's peers to their board members and thereby constituted corporate waste.[150] Relying on *Telxon Corp. v. Bogomolny*,[151] where the court held that an extraordinarily unusual equity award satisfied the waste standard, the plaintiff

142. *Id*. at 664.

143. *Id*.

144. Seinfeld v. Slager, No. 6462-VCG, 2012 WL 2501105, at *1 (Del. Ch. June 29, 2012).

145. *Id*. at *11.

146. *Id*. at *10.

147. *Id*.

148. *Id*. at *11.

149. *Id*.

150. *Id*.

151. 792 A.2d 964, 976 (Del. Ch. Nov. 1, 2001).

argued that the stocks awarded to Republic's directors were "unusual" and thus, under Delaware law, should qualify as waste.[152]

The *Slager* court held that there are limits on the applicability of the doctrine of ratification.[153] Consequently, the court refused to give any consideration to the ratification of Republic's Stock Incentive Plan in deciding whether the directors' actions should be subject to the business judgment rule or the entire fairness standard.[154] Instead, the fact that the plan lacked "sufficient definition" was held to be the reason why directors were not protected by the safe harbor of the business judgment rule.[155] The court enunciated a new rule: "Though the stockholders approved this plan, 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[.]"[156] Echoing the reasoning in *Sample*, the *Slager* court stated that a stockholder-approved carte blanche to the directors is not enough—"[t]he sufficiency of definition that anoints a stockholder-approved option or bonus plan with business judgment rule protection exists on a continuum."[157] The court further clarified that "[t]he 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."[158] If a board has absolute discretion, even if granted by a stockholder-approved plan, with little guidance as to the amounts or terms of the awards, the board will likely have the burden to show that the transaction is entirely fair.[159]

The *Slager* court concluded that Republic's Stock Incentive Plan had no effective limits because it authorized each director to grant and to receive an annual award of up to 1.25 million shares, which could amount to $21,691,250 per director per year, using the 2009 restricted stock value of $24.79 per share.[160] Accordingly, the directors were interested in awarding themselves substantial bonuses and thus had the burden to prove that the amounts they awarded to themselves were entirely fair.[161]

152. *See* Brief in Opposition to Defendants' Motion to Dismiss at 40, *Slager*, 2012 WL 2501105 (No. 6462-VCG).

153. *Slager*, 2012 WL 2501105, at *12.

154. *Id*.

155. *Id*.

156. *Id*. (emphasis in original).

157. *Id*.

158. *Id*.

159. *Id*.

160. *Id*. at *11.

161. *Id*. at *12.

A. *Interpreting* Slager*'s Standard for Reviewing Director Decisions Regarding Their Own Compensation*

Slager created a new legal standard for reviewing director decisions regarding their own compensation subject to Delaware law.[162] This new standard has created uncertainty about which principles corporate directors should follow in proposing compensation plans and in making compensation awards to themselves under a previously ratified compensation plan to receive protection of the business judgment rule. This note suggests that under the *Slager* standard, corporations and their board members might avoid liability if they adhere to the following guidelines: (1) director awards must be consistent with the explicit terms of a stockholder-approved compensation plan, (2) the compensation plan presented to the stockholders for approval must have "sufficiently defined terms" and (3) the plan must impose "meaningful limits" on each specific permissible award.

First, to qualify for business judgment deference, director equity awards should be consistent with the expectations of the stockholders who approved the compensation plan.[163] In other words, directors cannot exceed the authority granted to them by ratification and must strictly follow the plan's express provisions.[164] To illustrate, in *Weiss v. Swanson*, the court disallowed "spring-loading" and "bullet-dodging" stock option awards made to the company's directors where a specific provision in the plan authorizing such practices did not exist.[165] Similarly, in *Ryan v. Gifford*, in deciding whether to allow a derivative action, the court concluded that the practice of backdating[166] director stock options likely violated the express provision of the stockholder-approved incentive plan.[167] Following this logic, in *Criden v. Steinberg*, a case challenging stock options granted to corporate directors, the court authorized the board to reprice stock options where the stockholder-approved plan explicitly authorized repricing to incentivize performance or to encourage retention of key employees and non-employee directors.[168]

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162. *See* Arthur H. Kohn, *Delaware Case Raises Question About Structuring Director Compensation*, Harv. L. Sch. F. Corp. Governance & Fin. Reg. (Aug. 30, 2012, 9:14 AM), http://blogs.law.harvard.edu/corpgov/2012/08/30/delaware-case-raises-question-about-structuring-director-compensation/ (discussing *Slager*'s new standard); Edward M. McNally, *When May Directors Vote Themselves Bonuses?*, Del. Bus. Litig. Rep. (July 18, 2012), http://www.delawarebusinesslitigation.com/2012/07/articles/when-may-directors-vote-themselves-bonuses/.

163. *See* Weiss v. Swanson, 948 A.2d 437, 440 (Del. Ch. 2008).

164. Ryan *ex rel.* Maxim Integrated Prods., Inc. v. Gifford, 918 A.2d 341, 354 (Del. Ch. 2007).

165. *Swanson*, 948 A.2d at 443–44.

166. "Backdating" refers to the practice of a company issuing stock options to an executive on a certain date, while providing fraudulent documentation asserting that the options were actually issued earlier. *See* Charles Forelle & James Bandler, *The Perfect Payday*, Wall St. J. (Mar. 18, 2006, 11:59 PM), http://online.wsj.com/article/SB114265075068802118.html.

167. *Ryan*, 918 A.2d at 354–56.

168. No. 17082, 2000 WL 354390, at *3–4 (Del. Ch. Mar. 23, 2000).

Second, to ensure protection of the business judgment rule, directors should make equity awards pursuant to a stockholder-approved compensation plan that has "sufficiently defined terms."[169] Satisfying this element is difficult because there is limited case law interpreting this concept. The notion of having "sufficiently defined terms" in a compensation plan was first introduced in *In re 3COM Corp. Shareholders Litigation*.[170] There, 3COM stockholders approved a compensation plan that included caps on the number of shares that could be granted for each type of board service per year.[171] Specifically, the plan allowed payment of 60,000 shares to the board members, 80,000 to the chairman, and 24,000 to committee members.[172] In compliance with the terms of the plan, the board awarded each director between 22,500 and 45,000 shares having an approximate value of $650,000 per director.[173] The court afforded the defendants the protection of the business judgment rule and treated the awards as proper because "directors [did not] independently or unilaterally [grant] themselves stock options," instead, the stock options accrued under the terms of an established compensation plan with "sufficiently defined terms."[174]

The court in *Slager* distinguished Republic's plan from 3COM's to illustrate a lack of "sufficiency of definition," and emphasized that Republic's plan had no "bounds" because the plan provided directors with virtually unlimited discretion in determining their compensation.[175] Theoretically, Republic's board could have awarded each director an amount of stock units worth up to $21,691,250 annually, while the median compensation paid to a director at a corporation of Republic's size was $178,000.[176] Under *Slager*, the presence of a sufficient definition correlates with the level of discretion afforded to board members by the explicit terms of the stock plan. The more restrictions the plan imposes on director discretion, the more "sufficiently defined" a court will likely hold the terms to be. To comply with *Slager*'s new standard and to ensure that equity awards made to the company's directors were protected by the business judgment rule, the parties in *Slager*'s action stipulated to modify the terms of the plan to reduce the number of stock units that can be awarded to a non-employee director of Republic from 2.5 million to 15,000.[177]

Third, *Slager* seems to suggest that providing "meaningful limits" serves as a restriction on the board's discretion and ensures that the plan has "sufficiently

169. Seinfeld v. Slager, No. 6462-VCG, 2012 WL 2501105, at *12 (Del. Ch. June 29, 2012).

170. No. C.A. 16721, 1999 WL 1009210, at *3 (Del. Ch. Oct. 25, 1999).

171. *Id*. at *3 n.9.

172. 3COM Corp., Definitive Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Form 14A), at 16 (Aug. 20, 1998), *available at* http://www.sec.gov/Archives/edgar/data/738076/0000950005-98-000719.txt.

173. *In re 3COM Corp.*, 1999 WL 1009210, at *1 n.3, *4.

174. *Id*. at *3.

175. Seinfeld v. Slager, No. 6462-VCG, 2012 WL 2501105, at *11 (Del. Ch. June 29, 2012).

176. *See supra* Part II.B.

177. *See* April 1, 2013 Letter to the Hon. Sam Glasscock, III, *Slager*, 2012 WL 2501105 (No. 6462-VCG).

defined terms." The next logical step in decoding *Slager*'s standard is to identify the provisions of a compensation plan where these "limits" should be imposed. Analyzing *Slager* in conjunction with 3COM allows us to infer what specific "limits" articulated in an equity compensation plan would satisfy *Slager*. At a minimum, a plan must explicitly define the total number of shares authorized for issuance and the maximum number of shares that the plan can award to any eligible individual per year. Both Republic's and 3COM's plans satisfied this requirement. In *Slager*, the plan provided the total number of shares and the individual annual awards authorized. The total number of shares of common stock that could be issued under the plan was set at 10.5 million shares, 2.5 million was the maximum number of shares that could be awarded to any one eligible individual during fiscal year, and individual awards could not exceed $4 million.[178] Similarly in *3COM*, the company's director stock option plan set caps on the total number of shares available for grants under the plan—approximately 1.68 million[179]—and on the number of shares awarded to any eligible participant in a fiscal year in accordance with the type of board service.[180]

By further comparing *Slager* and *3COM*, it appears that tying director equity compensation to that of the company's peers[181] imposes a "meaningful limit"[182] and may establish a "sufficient definition" of a stock plan's terms. It is insufficient for a stock plan to merely articulate maximums on total and individual awards; these maximums must be "meaningful"—that is, based on some specific guidelines or criteria.[183] In *Slager*, where the court disallowed director awards without proving their entire fairness, the directors' annual compensation far exceeded the compensation of directors from any one of the company's peers.[184] In contrast, the plaintiff in *3COM* made no reference to compensation awarded to directors from the company's peer group. The only factual allegation in this regard was that the options had a value that was "quite large (at least $650,000 per director)," which could mean that the award at issue was comparable to

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178. *Slager*, 2012 WL 2501105, at *10; *see also* Republic Servs., Inc., Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Form 14A) (Apr. 10, 2007), *available at* http://www.sec.gov/Archives/edgar/data/1060391/000095014407003261/g06437def14a.htm.

179. Under an amendment to the original Director Stock Option Plan, on July 22, 1988 the board of directors approved an amendment reserving an additional one million shares of common stock. Added to this number were the original 167,000 shares under the original Director Stock Option Plan. 3COM Corp., Definitive Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Form 14A), at 15 (Aug. 20, 1998), *available at* http://www.sec.gov/Archives/edgar/data/738076/0000950005-98-000719.txt.

180. *Id*. at 17 (limiting eligible participants to directors who are not employees of the company).

181. "Peer group" usually refers to companies that operate in the same industry sector and are of similar size. *See Peer Group*, Investopedia, http://www.investopedia.com/terms/p/peer-group.asp (last visited Feb. 11, 2014).

182. *See* Joseph M. McLaughlin, Simpson Thacher & Bartlett LLP, Stockholder Challenges to Executive Compensation (Oct. 11, 2012), *available at* http://www.stblaw.com/google_file.cfm?TrackedFile=4B46116602DDECD896B179&TrackedFolder=585C1D235281AED996A07D5F9F9478AB5A90188899.

183. *Slager*, 2012 WL 2501105, at *12.

184. *Id*. at *11.

the compensation paid by 3COM's peers, or even that the plan disallowed awards in excess of those paid by their peers.[185] Therefore, it can be inferred that if a plan limits permissible awards by comparing them to those of the company's peers, the plan may significantly limit the directors' discretion and will more likely qualify as having "sufficiently defined terms." Thus, hypothetically, including a provision such as "the maximum number of shares that may be subject to award for director service shall be at the fiftieth percentile of the total equity awards paid to similarly situated directors of the companies in the peer group," where a peer group is identified by an independent compensation consultant, could guarantee the protection of the business judgment rule for directors who set their own stock awards in accordance with said plan.

Another guideline for satisfying the "meaningful limits" requirement can be extrapolated from the fact that the plan in *3COM* set ceilings on awards based on specific categories of service, such as lead director, member of a committee, or chair of the board. In contrast, in *Slager*, the plan did not incorporate these categorical ceilings. Consequently, if a plan correlates a permissible award to the time and energy required of directors, or at least to the categories of their board service, this would provide another restriction on director discretion. Accordingly, such a plan is more likely to satisfy *Slager*'s "meaningful limits" requirement.

It is important to note that "[t]he sufficiency of definition that anoints a stockholder-approved option or bonus plan with business judgment rule protection exists on a continuum."[186] To date, Delaware case law has given us only two reference points on this continuum: *3COM* and *Slager*. A plan similar to the one at issue in *3COM* (that includes the maximum number of shares authorized to be granted in aggregate, per year, per person, and sets ceilings on awards based on specific categories of service, such as lead director, member of a committee, or the chair of the board) will fall within the safe zone on the continuum. Alternatively, a plan with terms similar to the one at issue in *Slager* (that gives discretion to pay out annually to each director over one hundred times more than the average compensation paid to a director of a similarly situated company, allows unlimited director discretion, has no "meaningful maximums" or restrictions based on categories of director services) will likely raise some red flags.

Reviewing a few proxy statements recently filed with the SEC provides additional understanding of *Slager*'s "continuum." For example, an equity compensation plan presented for shareholder approval by Air Methods Corporation, which contained a provision giving board members the discretion to award all 1.8 million shares available for issuance under the plan to any single participant (including a board member) in any calendar year,[187] is unlikely to satisfy *Slager*'s standard because it lacks "sufficiency of definition." Thus, Air Methods Corporation's directors will have the burden to prove that the awards made under the plan are entirely fair if these awards were to be

185. *In re* 3COM Corp. S'holders Litig., No. C.A. 16721, 1999 WL 1009210, at *4 (Del. Ch. Oct. 25, 1999).

186. *Slager*, 2012 WL 2501105, at *12.

187. Air Methods Corp., Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Form 14A) (Nov. 31, 2012), *available at* http://www.sec.gov/Archives/edgar/data/816159/000114036112048365/formdefa14a.htm.

challenged by the company's shareholders. Alternatively, a director compensation plan approved by shareholders of pSivida Corporation, which sets an annual ceiling of 30,000 shares for each board member and 45,000 shares for the chairman, on the ground that these awards are consistent with the median equity compensation paid by the company's peers, will most likely be put in close proximity to 3COM's plan on the continuum because it has "sufficiency of definition" and should therefore fall within the purview of the business judgment rule.[188]

B. Protecting Directors from Liability Under Slager

Undoubtedly, *Slager* created a more stringent standard for reviewing director compensation awards. In light of the limited guidance from Delaware courts on the interpretation of *Slager*'s "meaningful limits," directors may need to find additional methods of protecting themselves from liability beyond ensuring that their company's compensation plan contains sufficiently defined terms and meaningful limits on directors' discretion in determining compensation. This note suggests that complying with certain principles of procedural prudence might provide directors with this additional protection.

To achieve additional protection, directors can shift the authority to determine director compensation from the directors to the stockholders. Instead of merely seeking shareholder approval of the general terms of an equity compensation plan, corporations can opt to solicit shareholder votes on stock awards made each year to their board members—"say-on-pay" on directors' annual equity compensation.

Pursuant to the NASDAQ and New York Stock Exchange rules adopted and approved by the Securities and Exchange Commission in 2003, all publicly traded companies were required to obtain stockholder approval for almost all equity-based compensation plans, material revisions to plans (including repricing), and individual non-plan grants.[189] However, these rules did not require companies to submit individual annual equity awards to stockholders for approval.[190] In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act amended the Securities Exchange Act of 1934 by adding section 14A,[191] commonly referred to as "say-on-pay," which requires companies to submit their executive compensation, including equity awards, to non-binding stockholder votes at least once every three years. However, the Act does not extend this requirement to director compensation. Even though it is not required, companies could give stockholders input on their directors' equity awards. In accordance with the doctrine of ratification described in Part III.B, "say-on-pay" approval of specific annual equity awards to corporate directors, if validly obtained, would serve as

188. pSivida Corp., Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Form 14A) (Oct. 25, 2012), *available at* http://www.sec.gov/Archives/edgar/data/1314102/000119312512435039/d411814ddef14a.htm.

189. Press Release, SEC, New Rules Require Shareholder Approval of Equity Compensation (June 30, 2003), http://www.sec.gov/news/press/2003-78.htm.

190. *Id.*

191. 15 U.S.C. § 78n-1 (2012).

a defense to a claim of a breach of fiduciary duty and would preclude judicial scrutiny of the award even if it is made under a plan lacking "sufficiently defined terms."[192]

But some theorists argue that stockholders are not well suited to set executive and director compensation primarily because the complexity of compensation schemes and the cost of understanding them requires ability beyond that of an average stockholder.[193] Therefore, these ordinary business decisions should be made by the company's management and not its stockholders.[194] Additionally, the cost of subjecting director equity awards to annual stockholder votes could be unreasonably high for both corporations and investors.[195] Furthermore, similar to cases involving "say-on-pay" votes—where a number of companies faced derivative litigation alleging that the boards breached their fiduciary duties by adopting proposed executive compensation plans despite a negative "say-on-pay" by stockholders[196]—the stockholders' negative votes on director compensation can lead to adverse litigation.

Another way of limiting director liability where awards are made pursuant to a plan lacking "sufficient definition" and "meaningful limits" is to have an independent advisor design the proposed equity compensation package. In accordance with section 141(e) of the General Corporation Law of the State of Delaware, directors "shall . . . be fully protected" from liability if they reasonably and in good faith rely on expert advice, but nevertheless produce a transaction that is unfair to the corporation or its stockholders, as long as the unfair aspect of the transaction arose from the expert's advice.[197] Delaware courts have limited the application of this statute to disinterested directors in duty of care cases, thereby excluding conflicted transactions despite the plain language of the statute that does not impose such limitations.[198] Nevertheless, Delaware courts will consider reasonable reliance on expert counsel as a pertinent factor when evaluating whether corporate directors met the standard of fairness in self-interested transactions.[199]

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192. *See* Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) ("[I]nformed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the basis of waste.").

193. *See, e.g.*, Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. Rev. 937, 955–56 (1993).

194. Roshan Sonthalia, *Shareholder Voting on All Stock Option Plans: An Unnecessary and Unwise Proposition*, 51 UCLA L. Rev. 1203, 1219 (2004).

195. *See* Elaine Buckberg & Jonathan Macey, Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation (2009), *available at* http://www.nera.com/upload/Buckberg_Macey_Report_FINAL.pdf.

196. *See, e.g.*, Dennis v. Hart, No. 11cv2271, 2012 WL 33199, at *2 (S.D. Cal. Jan. 6, 2012) (dismissing a stockholder-plaintiff's claim that the adverse advisory stockholder vote on the company's executive compensation rebutted the business judgment surrounding the board's decisions to increase executive compensation in 2010).

197. Del. Code Ann. tit. 8, § 141(e) (West 2013).

198. *See, e.g.*, Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 751 (Del. Ch. 2007) (holding that a section 141(e) defense is not available for conflicted directors who relied on the advice of a compensation consulting firm).

199. *Id.*; *see also* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1142 (Del. Ch. 1994).

Hence, even though retaining a compensation advisor might not help directors win a motion to dismiss under *Slager* or under Delaware courts' interpretation of section 141(e), it may strengthen their argument that the transaction was entirely fair in the later stages of litigation.

V. CONCLUSION

In the past few decades, Delaware courts have begun limiting the application of the business judgment rule by carefully scrutinizing director decisions and, as a result, their recent opinions have allowed more cases to survive pretrial motions asserting the business judgment rule defense.[200] Until recently, Delaware courts primarily relied on their prior broad interpretations of fiduciary duties and their notions of best practices in denying these pretrial motions.[201] However, in *Slager*, the Delaware Chancery Court heightened the standard of judicial review by requiring directors to show that decisions regarding their own compensation were either made under a stockholder-approved compensation plan with stringent restrictions on the directors' discretion, or were entirely fair to the corporation and its shareholders.[202] As a result, courts now have an additional precedent to consider in determining whether to dismiss a shareholder action challenging director compensation.

Presently, stock plans rarely include "sufficiently defined terms" or provide "meaningful limits"; they generally give board members unbridled authority to make decisions regarding their compensation. Thus, they are vulnerable to potential abuse by the board members entrusted with this authority. On the one hand, *Slager* creates an important accountability vehicle that should lead to additional care in director compensation decisions. On the other hand, it exposes directors to an increased risk of derivative lawsuits. This note's guidelines on interpreting *Slager*'s standard should assist directors in mitigating this risk. This note has suggested one way to interpret *Slager* and has proposed avenues that corporate directors can pursue to shield themselves from liability under *Slager*'s standard. Only time will tell how Delaware courts will apply and further enforce the standard *Slager* has introduced.

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200. *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 262 (Del. 2000) (dismissing plaintiffs' complaint challenging directors' decisions regarding the compensation paid to the company's former president, but giving the plaintiffs leave to replead); *In re* InfoUSA, Inc. S'holders Litig., 953 A.2d 963, 1003 (Del. Ch. 2007) (denying a motion to dismiss for failure to state a claim by finding that the complaint stated a claim for self-dealing transactions); Ryan *ex rel.* Maxim Integrated Prods., Inc. v. Gifford, 918 A.2d 341, 358 (Del. Ch. 2007) (denying a motion to dismiss for failure to state a claim and stating that the stockholder's allegations of breach of fiduciary duty were sufficient to rebut the business judgment rule); Sample v. Morgan, 914 A.2d 647, 669 (Del. Ch. 2007) (denying a motion to dismiss for failure to state a claim and finding the allegation of waste sufficient to overcome the presumption of the business judgment rule); *In re* Primedia Inc. Derivative Litig., 910 A.2d 248, 250 (Del. Ch. 2006) (denying a motion to dismiss for failure to state a claim because the court could reasonably infer self-dealing in breach of the duty of loyalty); Orloff v. Shulman, No. 852-N, 2005 WL 3272355, at *13–14 (Del. Ch. Nov. 23, 2005) (denying a motion to dismiss in part by finding that the plaintiffs should have the opportunity to conduct discovery on their claims of waste and breaches of fiduciary duty).

201. *See* cases cited *supra* note 200.

202. No. 6462-VCG, 2012 WL 2501105 (Del. Ch. June 29, 2012).