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Executive Compensation Lessons from *Freedman* v. *Adams*

By Rudolf Koch and Christopher H. Lyons

On January 14, 2013, in *Freedman v. Adams*, 58 A.3d 414 (Del. 2013), the Delaware Supreme Court reaffirmed that executive compensation decisions are business judgments vested in the board of directors that will rarely be second-guessed absent a showing that the board acted on an ill-informed basis or in bad faith. In *Freedman*, the plaintiff alleged that the board's decision not to adopt a compensation plan under Section 162(m) of the Internal Revenue Code – which provides public companies the ability to deduct from their taxes qualified, performance-based compensation in excess of $1 million paid to covered employees – constituted corporate waste. The Court of Chancery and then the Delaware Supreme Court disagreed.

Although the ruling in *Freedman* should be no surprise, to understand its true import it must be placed in context. Traditional compensation claims, alleging that particular compensation awards were excessive and thereby constituted corporate waste, have not fared well under Delaware law. Most fail the rigors of Rule 23.1 and are dismissed at the pleading stage. Apparently reacting to the difficulties facing such claims, enterprising plaintiffs' lawyers have taken a new approach to challenging compensation decisions in recent years. Rather than claim that compensation is excessive, plaintiffs have increasingly targeted companies and their directors in lawsuits alleging that they have materially misrepresented the tax deductibility of incentive compensation under Section 162(m) of the Internal Revenue Code.

The typical complaint is predicated on an allegation that the company has failed to comply with the technical requirements of Section 162(m), and that the IRS will inevitably disallow a deduction for incentive compensation. On this basis, plaintiffs argue that the proxy statement soliciting stockholder approval of the plan is false and misleading when it states that, if approved, the plan will result in favorable tax treatment pursuant to Section 162(m). Plaintiffs typically add claims for corporate waste (based on the alleged payment of nondeductible compensation) and unjust enrichment. Several complaints challenging seemingly compliant plans have withstood motions to dismiss; consequently, these cases have settlement value for the attorneys who bring them. *See* Rudolf Koch & Jason J. Rawnsley, "Section 162(m) Litigation: What We Know so Far," *The Review of Securities & Commodities Regulation*, Vol. 45, No. 20 (Nov. 21, 2012).

Freedman represented a new twist in Section 162(m) litigation. Instead of challenging the mechanics of a Section 162(m) plan, the plaintiff challenged the board's decision *not* to adopt such a plan. This article briefly summarizes *Freedman v. Adams* and sets forth practical lessons from the case when read in this context.

The Court's Decision

In *Freedman*, the plaintiff alleged that the directors of XTO Energy Inc. breached their fiduciary duties and committed waste by failing to structure cash bonuses as tax deductible. One form of relief the plaintiff sought was a mandatory injunction requiring the directors to implement a tax-deductible bonus plan under Section 162(m). After being sued, the company implemented a Section 162(m) plan, and the plaintiff later agreed to dismiss her case. The plaintiff's attorneys sought fees, arguing that the lawsuit had benefited the company and its stockholders by causing the company to adopt the plan. The Court of Chancery refused the request because, as the defendants argued, the claims were not meritorious when filed – that is, they would not have survived a motion to dismiss. *Freedman v. Adams*, 2012 WL 1345638 (Del. Ch. Mar. 30, 2012).

On appeal, the plaintiff challenged only the holding that the plaintiff had not stated a claim that the directors committed waste by failing to implement a Section 162(m) plan. The Delaware Supreme Court noted that the directors knew of the possible tax benefits of such a plan, but opted not to adopt one because they believed doing so would "constrain the compensation committee in its determination of appropriate

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bonuses." The court affirmed, reasoning that the "decision to sacrifice some tax savings in order to retain flexibility in compensation decisions is a classic exercise of business judgment."

The Court of Chancery had reached a similar result in *Seinfeld v. Slager*, rejecting claims that a bonus paid to an executive was wasteful because it was not tax deductible. It reasoned that a "decision to pursue or forgo tax savings is generally a business decision for the board of directors" and "there is no general fiduciary duty to minimize taxes."

It is Important for the Board to be Disinterested

Freedman highlights the importance of disinterest and independence with respect to compensation decisions. The *Freedman* court rejected the arguments that the outside directors had a self-interest in the decision not to adopt a Section 162(m) plan or were controlled by the officer-directors who would have been subject to that plan. Because disinterested outside directors constituted a majority of the board, the plaintiff bore the "heavy burden" of rebutting the presumption that the directors acted honestly, in good faith, and on an informed basis. The allegations were not up to that task.

Slager, on the other hand, shows that when directors are interested in a decision, the business judgment rule will not protect the directors. Although the directors in *Slager* were not interested in the executive bonus discussed above, the court found that they were interested in stock awards made to themselves. Although the stockholders had approved the stock incentive plan under which these awards were made, the court found that the plan provided "no effective limits" on how much compensation directors could award themselves. Because the plan theoretically permitted the directors to award themselves tens of millions of dollars worth of stock, the protections Delaware law affords to directors who receive stock under a stockholder-approved plan with "sufficiently defined terms" were unavailable. Accordingly, the court denied the motion to dismiss and held that the directors would bear the burden of proving that the awards were entirely fair.

The outer limits of what constitutes "sufficiently defined terms" for a stock incentive plan, such that stockholder approval will provide directors the protections of the business judgment rule, remain unclear. Helpful in this regard is the case distinguished by the *Slager* court: in *In re 3COM Corp. Shareholders Litigation*, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999), the Court of Chancery found a plan sufficiently definite to confer business-judgment-rule protection. Notably, the board in *3COM* sought stockholder approval to expand the option plan. That is, the limits under the existing plan had been tight enough that when circumstances required significantly larger stock option awards, those awards required further stockholder approval. In *Slager*, by contrast, the plan permitted the directors to award themselves nearly 30 times the amount of the largest challenged award without stockholder approval.

Thus, a key question is whether the plan meaningfully constrains the directors' unilateral ability to increase their own compensation. With respect to compensation a director earns *qua* director, the precise limits await further developments in the law, but one imagines that limiting the yearly increase in a directors' compensation to a reasonable percentage of the prior year would adequately balance the need for flexibility with the need for meaningful constraint. Companies should also consider separating incentive compensation plans for directors from those for executives, to reduce the likelihood that a board is found interested in executive-compensation decisions.

It is Important for the Board to be Informed

Freedman also underscores another bedrock principle underlying the business judgment rule – that directors must act on an informed basis. It was important to both the Court of Chancery and the Delaware Supreme Court that "the XTO board was aware of the 'tax deduction issue,'" but consciously "did not believe that its compensation decisions should be 'constrained' by Section 162(m)."

Proxy Statement Disclosures are Important

Finally, *Freedman* demonstrates the importance of compensation-related proxy statement disclosures. In *Freedman*, the proxy disclosed that the compensation committee was informed of the potential tax benefits of adopting a Section 162(m) plan and chose not to take advantage of its benefits. Similarly, precise disclosure language was important in *Seinfeld v. O'Connor*, 774 F.Supp. 2d 660 (D. Del. 2011), where the plaintiff alleged that the proxy statement misled stockholders into believing that bonus payments would be tax deductible, when in fact those payments (allegedly) would not be deductible because they did not comply with Section 162(m). The court rejected this argument because the proxy statement stated only that the plan was *intended* to comply with Section 162(m).

Proxy statements have also assumed additional importance due to plaintiffs' recent efforts to enjoin compensation-related stockholder votes at annual meetings by alleging that executive-compensation disclosures are false and misleading. Plaintiffs have met limited success in these efforts, which are reminiscent of the many merger-related lawsuits brought primarily seeking additional disclosures. Stay tuned.

Conclusion

Enterprising plaintiffs' lawyers continue to find novel ways to challenge executive compensation decisions. Often, the precise language in a company's proxy statement dictates whether a challenge to an executive compensation plan or decision withstands a motion to dismiss (or results in an injunction). Boards, and their counsel, need to remain informed of the latest case law developments to limit the risk of being targeted in these suits.

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