Securities Litigation REPORT

October 2011 ■ Volume 8 ■ Issue 9

Avoiding Shareholder Suits Challenging Executive Compensation

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A number of derivative suits have been filed in recent months alleging that the senior executive compensation plans at public companies do not comply with § 162(m) of the Internal Revenue Code. Section 162(m) provides that any compensation paid to the CEO and next three highest compensated proxy officers (other than the CFO) in excess of $1 million per year is not tax deductible unless, among other things, the compensation is subject to objective performance metrics that have been disclosed to and approved by shareholders.

The complaints generally allege that the performance goals established by the plans are not sufficiently objective to comply with § 162(m) and that the purported failure of the plans to comply with § 162(m) renders the required proxy disclosure false and misleading in violation of § 14(a) of the Securities Exchange Act. In addition, the complaints allege that the provision of nondeductible compensation to senior executives constitutes waste, unjust enrichment of the executives and a breach of the directors' duty of loyalty.

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We, the authors and our firm, view these suits as meritless and symptomatic of the excesses that led to reform in other areas of shareholder litigation. In each of the challenged plans that we have reviewed, the terms of the plans do, in fact, comply with § 162(m), and the disclosure relating to the plans expressly states that nondeductible compensation may be granted if the compensation committee determines that doing so is in the best interest of the company.

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Moreover, the complaints that we have reviewed, alleging that the performance goals are not sufficiently objective to comply with § 162(m), reflect a basic lack of understanding of the operation of typical § 162(m) plans in which the compensation committee establishes an objective § 162(m) goal, which, if met, would then provide the committee with the discretion to make an award below the amount authorized by the plan. This "plan within a plan" structure is expressly permitted by the Internal Revenue Code.

In addition, there is no legal obligation for compensation committees to grant only compensation that is deductible under Section 162(m).

In addition, there is no legal obligation for compensation committees to grant only compensation that is deductible under § 162(m). The courts have largely gotten this right by ruling against the plaintiffs on motions to dismiss (see, for example, U.S. District Justice Leonard Stark's well-reasoned opinion in *Seinfeld v. O'Connor*).[1]

These suits nonetheless serve as a reminder that careful attention must be paid to the design and administration of plans intended to comply with § 162(m) and that disclosure relating to tax deductibility must be carefully drafted. Companies should design plans to make compliance with § 162(m) as easy and straightforward as possible. The "plan within a plan" design[2] is the most efficient means of achieving this goal.

Equally important, proxy disclosure should not guarantee that all compensation awarded will comply with § 162(m). Instead, proxy disclosure should say that plans are "intended to" comply with § 162(m) and that the company may elect to provide nondeductible compensation.

NOTES

1. *Seinfeld v. O'Connor*, 774 F. Supp. 2d 660 (D. Del. 2011).
2. *See* Wachtell Lipton's memo, "Executive Compensation in a Challenging Economic Environment" (December 3, 2008), available at http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.16372.08.pdf.