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Delaware Supreme Court Upholds Board Compensation Decision

Earlier today the Delaware Supreme Court upheld a Chancery Court determination that a board did not commit waste by consciously deciding to pay bonuses that were non-deductible under Section 162(m) of the Internal Revenue Code (*Freedman v. Adams*, Del. Supr., __ A.2d __, No. 230, 2012, Berger J. (Jan 14, 2013)). Unlike claims of gross negligence, claims of waste are not subject to exculpation or indemnification by the company and therefore have the potential for personal liability of directors.

The original suit was brought in 2008 by a shareholder of XTO Energy (later acquired by ExxonMobil) as a derivative claim. The suit alleged that XTO's board committed waste by failing to adopt a plan that could have made \$130 million in bonus payments to senior executives tax deductible. The board was aware that, under a plan that qualifies for the "performance based compensation" exception of Section 162(m), the company could have deducted its bonus payments, but, as the company disclosed in its annual proxy statement, the board did not believe that its compensation decisions should be constrained by such a plan. The Chancery Court held that the shareholder failed to state a claim. The Supreme Court agreed, holding that the decision to sacrifice some tax savings in order to retain flexibility in compensation decisions is a classic exercise of business judgment.

Like other recent Section 162(m) suits about which we have written, this suit serves as a reminder that careful attention must be paid to the design and administration of plans intended to comply with Section 162(m) and that disclosure relating to tax deductibility must be carefully drafted. Helpful in this case was the fact that the board was aware of Section 162(m), made a conscious decision not to avail itself of Section 162(m) and disclosed its reasons for so deciding. Moreover, this case serves as a reminder that aspirational "best practices" are not synonymous with legal requirements that may result in liability. Indeed, the Supreme Court expressly stated that "even if the decision was a poor one for the reasons alleged by Freedman, it was not unconscionable or irrational."

Thus once again, the Delaware courts have demonstrated that directors need not be deterred from paying executives in amounts and forms that they deem necessary or advisable to attract, retain and incentivize executives. Indeed, doing this effectively is one of the highest priorities for any board of directors.

Paul K. Rowe
Jeremy L. Goldstein