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Client Alert

January 2013

Delaware Supreme Court Rejects Challenge to Executive Compensation Decisions

On January 14, 2013, the Delaware Supreme Court affirmed the Court of Chancery's ruling that a complaint failed to state a claim for waste in challenging a board of directors' executive compensation decisions. The opinion reaffirms that executive compensation decisions are the "classic exercise of business judgment" and, when made by a majority of disinterested and independent directors, will result in deferential review under the business judgment rule.

Background and Court's Decision

The case, *Freedman v. Adams*, involved a stockholder derivative suit that claimed the corporation's board of directors had committed "waste" by failing to structure its executives' bonuses as tax-deductible payments.[1] Specifically, the plaintiff claimed that the bonuses should have been structured as "performance-based compensation" under Section 162(m) of the Internal Revenue Code.[2] The challenged bonuses totaled approximately $130 million, which the plaintiff alleged would have resulted in $40 million in savings if the bonuses had qualified as performance-based compensation under Section 162(m). The corporation's proxy statement, however, disclosed that while the compensation committee was aware of the tax advantages available under Section 162(m), it did not believe its decisions should be "constrained" by such a plan.[3]

The Delaware Supreme Court held that, to state a claim for waste, a plaintiff must allege with particularity "that the board authorized action that no reasonable person would consider fair" and has the burden "of proving that the exchange was so one sided that no business person of ordinary, sound judgment would conclude that the corporation has received adequate consideration." Applying that standard, the Delaware Supreme Court affirmed the lower court's decision that the plaintiff failed to state a claim.

First, the court found that the complaint "does not allege that any of the bonuses paid to [the corporation's] executives actually would have been tax deductible under [a Section 162(m)] plan." Second, the court stated that the board of directors "was aware of the tax law at issue, but intentionally chose not to implement a Section 162(m) plan" because it believed such a plan "would constrain the compensation committee in its determination of appropriate bonuses." The court continued that "[t]he decision to sacrifice some tax savings in order to retain flexibility in compensation decisions **is a classic exercise of business judgment**" (emphasis added).

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[1] *Freedman v. Adams*, C.A. No. 4199, mem. op. (Del. Jan. 14, 2012).

[2] Compensation can qualify as performance-based compensation under Section 162(m) if, among other things, the compensation will be payable only if objective and pre-established performance goals are achieved.

[3] The requirements of the Section 162(m) advantage can limit a compensation committee's flexibility in designing a compensation program. For example, compensation that is earned on account of continued service, compensation that is earned based on subjective evaluations or criteria, and compensation paid based on a retrospective review of performance will not qualify as performance-based compensation under Section 162(m).

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Implications

Freedman reaffirms a Delaware precept that executive compensation decisions are business judgments vested in the board of directors that rarely will be overturned. The Court of Chancery reached a similar result last year in *Seinfeld v. Slager*, where the plaintiff alleged that compensation paid to an executive was wasteful because it was not tax-deductible to the corporation.[4] Among other things, the *Seinfeld* court held that a "decision to pursue or forgo tax savings is generally a business decision for the board of directors."

Freedman is also a reminder about the importance of board and compensation committee process and proxy statement disclosure surrounding executive compensation. Here, the corporation's disclosures made clear that the compensation committee was aware of the potential tax benefits available under Section 162(m) and chose not to take advantage of such benefits. It also disclosed the reason why the compensation committee made that decision. While the business judgment rule should still protect the directors' decision, these disclosures directly rebutted the plaintiff's attack by explicitly stating that such matters had been considered.

Freedman also illustrates the importance of disinterested and independent decision-making, which generally results in business judgment rule protection. It can be contrasted, however, with a more controversial ruling in the *Seinfeld* case. There, the plaintiff challenged, among other things, grants of restricted shares that were awarded by the board to each director. The grants were made pursuant to a stockholder-approved equity plan that limited the number of restricted shares that an individual could receive in any given year, but it did not place any limits on the aggregate monetary value of those restricted shares.[5] The court held that, because the plan "lack[ed] sufficient definition," the stock grants were "self-dealing transactions" that were reviewable under the exacting "entire fairness" standard. The court contrasted a prior Delaware decision in *In re 3COM Corp.*,[6] where it said the plan at issue had "sufficiently defined terms" that imposed limits on the board's discretion and was thus entitled to review under the business judgment rule.

Finally, *Freedman* reaffirms the high standard in proving a waste claim in Delaware. In *Disney*, for example, the Delaware Supreme Court affirmed dismissal of a complaint challenging the terms of an employment agreement, noting that "[a] claim of waste will arise only in the rare, 'unconscionable case where directors irrationally squander or give away corporate assets.'"[7] Nevertheless, corporations should remember that in *In re Citigroup Inc.*, the Court of Chancery refused to dismiss a waste claim challenging an allegedly excessive severance award given to an outgoing chief executive officer.[8]

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[4] *Seinfeld v. Slager*, C.A. No. 6462-VCG, mem. op. (Del. Ch. June 29, 2012).

[5] Because of the company's then-current trading price, a maximum grant of restricted shares could have equaled approximately $22 million for each director. The grants actually made, however, were equal to approximately $750,000 and $215,000, respectively, in the two years at issue. The court did not address the merits of the plaintiff's challenge to those grants under the entire fairness standard.

[6] *In re 3COM Corp. S'holder Litig.*, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999).

[7] *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 207, 74 (Del. 2006) (quoting *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)).

[8] *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106 (Del. Ch. 2009).

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