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Delaware Federal Court Issues Significant Ruling Concerning Impact of Executive Compensation Provisions of the Internal Revenue Code on Delaware Corporate Law Governing Shareholder Voting

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In a case of apparent first impression regarding the impact of the shareholder voting provisions of Internal Revenue Code ("I.R.C.") § 162(m) on state corporate law, Judge Sue L. Robinson of the U.S. District Court for the District of Delaware recently held that the federal statute did not preempt Delaware law. Freedman v. Redstone, et al., Civ. No. 12-1052-SLR, 2013 WL 3753426, (D. Del. July 16, 2013). Specifically, Judge Robinson held that I.R.C. § 162(m)'s provision that certain executive compensation is tax-deductible only if it is awarded pursuant to a plan approved by shareholders did not preempt Delaware state law that permits a corporation, in its charter, to designate certain classes of shares as non-voting. This ruling has potential ramifications in other cases in which federal law intersects with state law on matters of corporate governance. Judge Robinson also dismissed the plaintiff's derivative claim that the directors violated their fiduciary duties by awarding compensation not in compliance with the terms of the prior plan and I.R.C. § 162(m).

The Direct Claim – The Court Rejects Plaintiff's Contention That I.R.C. § 162(m) Overrides Delaware Corporate Law on Shareholder Voting

In August 2012, plaintiff Robert Freedman, a holder of Class B shares of Viacom Inc., brought suit against Viacom and its directors seeking a re-vote on Viacom's Senior Executive Short-Term Incentive Plan, as amended and restated effective January 18, 2012 (the "2012 Senior Executive STIP"), that was approved by a vote of Viacom's Class A shares at the company's Annual Meeting of Stockholders in March 2012. Under Viacom's charter, Class A shares are voting shares and Class B shares are non-voting shares. The 2012 Senior Executive STIP was designed to comply with I.R.C. § 162(m), which requires that certain conditions be met in order for performance-based compensation of a company's CEO and four highest-paid employees to be tax-deductible. One of those conditions is that the compensation be awarded pursuant to a plan whose material terms are disclosed to and "approved by a majority of the vote in a separate shareholder vote." 26 USC § 162(m)(4)(c)(ii).

Plaintiff argued that this provision of I.R.C. § 162(m) "requires all shareholders to have a vote on" the plan, regardless of whether the shares are designated as voting or non-voting in the company's charter. Plaintiff contended that Section 151(a) of the Delaware General Corporation Law, which authorizes charter provisions allowing both voting and non-voting stock, is inconsistent with I.R.C. § 162(m) and is preempted by the federal statute. According to plaintiff, because I.R.C. § 162(m) simply refers to a "shareholder vote" without specifying holders of "voting stock" or "stock entitled to vote," Congress must have intended the statute to require a vote of all shareholders, including those holding non-voting stock. Delaware law to the contrary, plaintiff argued, was preempted because "voting on a compensation plan in order that it provide tax deductible compensation is a matter of federal law concerning US income taxes, an exclusive federal matter." Op. at 23.

The court rejected plaintiff's preemption argument and held that I.R.C. § 162(m) did not require that non-voting shares be included in the vote. The court reasoned that "[i]n areas of traditional state regulation, we assume that a federal statute has not supplanted state laws unless Congress has made such an intention clear and manifest." Op. at 23. The court concluded that corporate governance (which includes matters such as the voting rights of shareholders) is an area of law firmly relegated to the states, and plaintiff had offered no evidence that Congress intended I.R.C. § 162(m) to supplant state law on the issue. Op. at 24.

The court concluded that the Treasury regulations implementing I.R.C. § 162(m) did not lead to a contrary result, but instead supported the court's holding. According to those regulations, "[t]he material terms of a performance goal are approved by shareholders if, in a separate vote, a majority of the votes cast on the issue (including abstentions to the extent abstentions are counted as voting under applicable state law) are cast in favor of approval." Treas. Reg. §162-27(e)(2)(vii). The court reasoned that the regulations do not suggest that the shareholder vote must include every shareholder, but rather require a majority "of the votes cast on the issue" and explicitly give deference to state law with respect to how abstentions count in a vote. Op. at 25-26. The court also cited the preamble to the proposed amending regulations, which explained that the regulation was intended "to reflect the fact that certain shares may have more than one vote." Op. at 25-26 n.13 (citing Disallowance of Deductions for Employee Remuneration in Excess of $1,000,000, 59 Fed. Reg. 231 (proposed Dec. 2, 1994) (codified at 26 C.F.R. § 1.162-17)).

Accordingly, while the I.R.C. governs the deductibility of compensation expenses for federal tax purposes, the question of which shareholders are entitled to vote in a "shareholder vote" pursuant to I.R.C. § 162(m) is governed by state law. The consequences of the court's application of preemption jurisprudence to shareholder approval requirements in other areas related to corporate governance and executive compensation will be seen over time. In some instances where federal tax law imposes a shareholder approval requirement, the primacy of state law rules for determining the adequacy of the vote is explicit. This is the case, for instance, in the Treasury regulations relating to tax-favored "incentive stock options" and employee stock purchase plans. Treas. Reg. §1.423-3. In situations where the federal requirement is not so clearly elaborated, however, Judge Robinson's decision should prove a useful reaffirmation of the longstanding principle that when Congress wishes to override State law in a subject area traditionally left for State regulation, it must do so explicitly.

The Derivative Claim – The Court Holds That the Complaint Failed to Allege a Clear Violation of the Plan

Plaintiff's derivative claim alleged that members of Viacom's Board violated their fiduciary duties in their implementation of Viacom's 2008 Senior Executive Short-Term Incentive Plan (the "2008 Senior Executive STIP"). Plaintiff alleged that the compensation awarded pursuant to the 2008 Senior Executive STIP was in violation of the terms of that plan and

I.R.C. § 162(m) because the Compensation Committee of the Board used subjective factors in determining awards, and that this violation precluded reliance on the business judgment rule and therefore excused plaintiff's failure to make a pre-litigation demand on the Board to bring suit. According to plaintiff, both I.R.C. § 162(m) and the terms of the 2008 Senior Executive STIP required that any award be based on objective factors and "payable solely on account of the attainment of one or more performance goals" previously determined by the Compensation Committee. Defendants contended that the awards were in compliance with the plan because subjective factors were only taken into account in order to *reduce* the maximum amount of compensation awarded under the 2008 Senior Executive STIP if the pre-determined performance goal had been met. Under the 2008 Senior Executive STIP, the maximum award was deemed earned if the performance goal was met, but it could be reduced – and was reduced – by the Compensation Committee based on its consideration of additional subjective and objective factors. If the performance goal was not met, no compensation could be paid pursuant to the plan.

This "plan within a plan" structure for plans subject to I.R.C. § 162(m) is fairly common, but as far as we are aware, no court had previously approved, disapproved, or commented upon it. In *Freedman*, Judge Robinson determined that the complaint did not sufficiently allege a "clear and undisputed violation [of the terms of the 2008 Senior Executive STIP], let alone a violation that, standing alone, would create a reasonable doubt that the Board acted without knowledge or intent." Op. at 21-22. The court therefore dismissed the complaint on the grounds that it did not adequately allege that demand on the Board of Directors to bring suit was excused.

Shearman & Sterling LLP partners Stuart J. Baskin and Jaculin Aaron represented Viacom in the lawsuit, with the assistance of Executive Compensation & Employee Benefits Group partner Linda E. Rappaport and counsel George T. Spera Jr.

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