



Compensation | January 12, 2012 | CFO.com | US

## Not Just a Tax Issue: Lawsuits Crop Up over IRS 162(m)

Shareholders accuse companies of making false and misleading executive-compensation and tax disclosures.

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Proxy season is now upon us, and a key task is to evaluate whether shareholder approval is needed for any executive-compensation plan. One of the typical reasons to seek shareholder approval is to qualify for tax-deduction relief under Section 162(m) of the Internal Revenue Code. By and large, seeking shareholder approval for that purpose has been viewed as a relatively routine task. But recent shareholder derivative lawsuits suggest that public companies should take a careful look at disclosures that solicit Section 162(m) shareholder approval.

Section 162(m) generally limits the amount that a public company may deduct as compensation paid to each executive officer named in the proxy statement (other than the CFO) to \$1 million per year. There are exceptions to that limitation, the most important of which is for so-called performance-based compensation. If an item of compensation qualifies as performance-based, it may be deducted regardless of the amount involved (subject to it being reasonable).

There are several requirements in order for compensation to be “performance-based” for this purpose. Payment must be contingent upon achieving one or more preestablished, objective performance goals (stock options with an exercise price not less than the stock’s fair-market value on the grant date are deemed to meet this requirement). A compensation committee of sufficiently independent directors must approve the performance goals and certify whether those goals have actually been met prior to payment (no certification is required for stock options). In addition, if the compensation committee can vary the targets for the performance goals from time to time, the material terms of the goals must generally be reapproved by shareholders every five years.

Shortly after the Enron debacle, the IRS began reviewing executive compensation as part of its corporate income-tax audits. The audits included a focus on Section 162(m) compliance and sometimes resulted in reversal of tax deductions due to midyear changes in performance goals, inadequate documentation, compensation-committee members who were not sufficiently independent, and failure to obtain shareholder reapproval in a timely manner. Many of these errors were unintentional and capable of being corrected fairly easily with tighter administrative procedures.

While revenue agents will look at Securities and Exchange Commission filings as part of these audits, the IRS from all accounts has not challenged the sufficiency of Section 162(m) proxy disclosures provided to shareholders. One of the requirements for the performance-based compensation exception is that the material terms of the performance goal under which the compensation is to be paid must be adequately disclosed to shareholders under Exchange Act standards. If the disclosure is inadequate, the compensation may be considered nondeductible.

Plaintiffs’ lawyers are now filing shareholder derivative lawsuits challenging executive compensation based on Section 162(m) and the securities law disclosure requirement. Among other things, these lawsuits include allegations that:

- Payments under the awards made by the compensation committee were substantially certain to occur (i.e., the goals were not preestablished sufficiently in advance).
- The description of the business criteria that can be used for performance goals was false or misleading and/or the performance goals were too vague (such as use of non-GAAP financials).
- The company did not follow a practice of limiting nonperformance-based compensation to less than \$1 million (e.g., salary and other benefits payable in excess of \$1 million).

- Too much discretion was retained by the compensation committee to vary payments in violation of IRS regulations.
- The company will pay the compensation regardless of whether the shareholders approve the performance goals.

Based on those types of allegations, the complaints state that the compensation covered by these disclosures in excess of \$1 million is nondeductible under Section 162(m), and payment of it results in corporate waste, breach of fiduciary duties, and/or unjust enrichment. Requested relief has ranged from recovering previously paid compensation to seeking to hold directors and certain named executive officers liable for damages, to equitable relief prohibiting future compensation awards under previously approved plans.

It remains to be seen whether these lawsuits will hold up in the courts. It seems unlikely that plaintiffs will be able to prove the allegations, and some of the positions are directly in conflict with longstanding public-company practices that have not been challenged by the IRS, such as using a maximum payment limit that may be unlikely to restrict compensation payments.

What we do know is that courts are not automatically dismissing Section 162(m) lawsuits at the motion-to-dismiss stage (i.e., before the beginning of discovery, such as the issuance of subpoenas and the taking of depositions). If a court allows for discovery, defending against this type of action can be time-consuming, expensive, and embarrassing, and it could make obtaining a favorable say-on-pay vote more difficult. It's worth considering the allegations in these suits when preparing Section 162(m) disclosures this proxy season and administering awards and payments under Section 162(m) plans.

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