Technology Companies and Section 162(m) – Minimizing Litigation Risks

While compliance with Section 162(m) of the Internal Revenue Code – the provision that, generally, limits the federal income tax deduction that a public company may take for the compensation paid to its senior executives to $1 million per year – has long presented challenges for technology companies, in recent years, the provision has also become a fertile source of executive pay-oriented shareholder lawsuits; thereby requiring companies to ensure that they understand – and are prepared to avoid – the potential traps that have led to such litigation.

This Thoughtful Pay Alert summarizes the recent Section 162(m)-related litigation issues that we have seen and offers suggestions to help you minimize the potential risks that can arise in complying with this complex statute.

Section 162(m) – A Brief Overview

Section 162(m) prohibits a public company from taking a federal income tax deduction for any compensation in excess of $1 million paid to its chief executive officer and its three other most highly-compensated executive officers (but specifically excluding its chief financial officer) in any taxable year. Compensation generally includes all remuneration for services performed by a covered executive officer, whether or not the services were performed during the same taxable year in which the compensation is paid.

This $1 million deduction limit does not apply to certain types of compensation, however, including performance-based cash bonuses and full value equity awards, and stock options or stock appreciation rights ("SARs") if such awards satisfy certain conditions involving the grant and terms of the awards. These conditions include a requirement that the material terms of the plan pursuant to which the compensation is paid be approved by shareholders.

Disclosing Your Section 162(m) Practices in Your Proxy Statement

Once a technology company is required to provide full executive compensation disclosure in its SEC filings (which will occur once the company no longer qualifies as an "emerging growth company" – that is, generally when the company's annual revenues exceed $1 billion), as part of its Compensation Discussion and Analysis the company must address the impact of the accounting and tax treatment of its specific compensation arrangements. For most companies, this discussion will cover the implications of the Section 162(m) deduction limit and the company's policy and practices with respect to compliance with this provision.

Three Steps to Minimize Your Exposure to Potential Section 162(m)-Related Litigation

- Avoid "boilerplate" disclosure in your Compensation Discussion and Analysis about your Section 162(m) compliance practices; be sure to make clear that your compensation committee reserves the discretion to award compensation that is not deductible for federal income tax purposes if it determines that such awards are in the best interests of your company and your shareholders.
- Be sure to get your compensation advisors involved in the design of your annual and long-term incentive compensation arrangements (including your equity plans) at an early stage to develop and implement your Section 162(m) compliance strategy.
- To minimize the risk of a lawsuit alleging a failure to comply with the technical conditions of the "performance-based compensation" exception to the deduction limit, review your equity and other incentive compensation plans on at least an annual basis to identify any potential compliance issues.

Recently, companies have become vulnerable to shareholder lawsuits asserting that this Section 162(m)-related disclosure is false or misleading. Typically, these lawsuits have made one or both of the following allegations:

- The company's disclosure stated or implied that the company has taken all necessary steps to ensure full deductibility of its senior executives' annual bonus and equity awards when this was, in fact, not true; and
- The company's disclosure failed to state that certain forms of compensation would be paid to its senior executives without regard to its deductibility for purposes of Section 162(m).

While, to date, these lawsuits have not proven successful, as with all problematic litigation they can serve as an unnecessary distraction for management and an unwelcome drain on a company's time and resources. Given our observation that, over the years, some Section 162(m)-related disclosures have become vague and unfocused, these lawsuits are a reminder that it is important to draft these disclosures carefully. Specifically, we recommend that companies observe certain guidelines when drafting Section 162(m)-related disclosures for their CD&A or equity plan proposals:

- Avoid "boilerplate" language or simply repeating the same statement from the prior year's proxy statement;
- Do not state (or imply) that all performance-based compensation is compliant with the "performance-based compensation" exception if it is not;
- Include a statement that there is no guarantee that all compensation will be Section 162(m)-compliant, as well as a statement that the board compensation committee may decide, in its discretion, to pay incentive-based compensation or grant equity awards that do not qualify for the "performance-based compensation" exception (or that may not be deductible for purposes of Section 162(m)) if it determines that this is in the best interests of the company and its shareholders; and
- Consider having litigation counsel review the disclosure to identify potential risk areas (such as vague or potentially misleading statements).

Other Section 162(m)-Related Litigation

In addition to the disclosure-related litigation described above, other Section 162(m)-related lawsuits also have proliferated in the past three years with approximately 20 lawsuits since 2011 centered on, or containing, a Section 162(m)-related claim.

Many of these lawsuits have involved one or more technical issues, primarily related to the "performance-based compensation" exception. For example, the following allegations (among others) have appeared:

- The company failed to comply with a per-individual award limit in granting an equity award to a senior executive subject to Section 162(m);
- The board compensation committee exercised its discretion to increase the amount of an incentive award made pursuant to an incentive compensation plan intended to qualify for the "performance-based compensation" exception (Section 162(m) permits the exercise of only "negative" discretion in this instance); and
- The company failed to disclose, with meaningful specificity, the material terms and conditions of the incentive compensation plan, with particular attention being given to the performance goals pursuant to which the compensation would be paid.

While much of this Section 162(m)-related litigation can be characterized as "nuisance" lawsuits, claims involving technical violations of Section 162(m), particularly the detailed requirements of the "performance-based compensation" exception, can cause serious problems for companies. For example, we are aware of at least two companies that were forced to rescind equity awards to senior executives when it was established that, as alleged, they had granted such awards at levels that exceeded the per-individual award limit specified in their equity plan.

Consequently, we recommend that you consider taking the following actions to minimize the risk of the Section 162(m)-related claim. We also note that, in addition to reducing your litigation risk, these steps are useful to ensure the integrity of your compensation-related income tax deductions and the proper administration of your equity plan:

- Get your legal counsel and other compensation advisors involved in the design of your annual and long-term incentive compensation arrangements (including your equity plans) at an early stage to develop and implement your Section 162(m) compliance strategy; thereafter, have your legal counsel review these plans and arrangements on an annual basis to evaluate your ongoing compliance with Section 162(m), as well as to recommend any actions to enhance the administration of these arrangements;

- Proactively address any identified compliance issues before filing your proxy statement describing your incentive compensation arrangements and Section 162(m) practices;
- Educate your board compensation committee about Section 162(m), including current developments, so that it can anticipate and address potential compliance issues before they become problems; and
- Have the board compensation committee regularly consider its policy and practices with respect to the Section 162(m) deduction limit, with an eye towards identifying the treatment of specific plans and arrangements well in advance of when technical compliance will be required.

Since the implementation of Say-on-Pay in 2011, executive compensation has come under the spotlight like never before. Therefore, it's important to understand that professional plaintiffs and their attorneys are scrutinizing the details of your executive compensation disclosure – no matter how innocuous – to find any colorable basis to file suit. You should also expect that your profile will be higher in years when you have a possible pay-for-performance disconnect and/or an equity plan proposal on the agenda for your annual meeting of shareholders, since that will give these parties more information to scrutinize.

While there are no solutions that are guaranteed to insulate you from a lawsuit, we believe that if you are aware of the potential pitfalls, draft your disclosure carefully, and ensure that your are complying with the requirements of Section 162(m) and its related rules, you can manage the risk that has arisen in this area and reduce, if not eliminate, your chances of being a target for a Section 162(m)-related lawsuit.

Interested in Other Section 162(m)-Related Issues?

For a discussion of the "transition" rule available to newly-public companies that enables them to postpone compliance with the Section 162(m) deduction limit for up to three years following their IPO, see our Thoughtful Pay Alert, Technology Companies and Section 162(m): Compliance Relief for Newly-Public Companies »

Need Assistance?

Compensia has extensive experience in helping pre-IPO and newly-public companies understand and prepare for their corporate governance, reporting, and other obligations as a public company, including strategies for complying with Section 162(m) of the Internal Revenue Code. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance in assessing their likely impact on your executive compensation plans, please feel free to contact us. ■

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

Silicon Valley

1731 Technology Drive
Suite 810
San Jose, CA 95110
408.876.4025

Timothy J. Sparks, President
tsparks@compensia.com
408.876.4024

Jason Borrevik
jborrevik@compensia.com
408.876.4035

Thomas G. Brown
tbrown@compensia.com
408.876.4023

Susan Gellen
sgellen@compensia.com
408.907.4302

Tom LaWer
tlawer@compensia.com
408.907.4309

San Francisco

1550 Bryant Street
Suite 740
San Francisco, California 94103
415.462.2990

Mark H. Edwards, Chairman
medwards@compensia.com
415.462.2985

Mark A. Borges
mborges@compensia.com
415.462.2995

Erik Beucler
ebeucler@compensia.com
408.907.4314

Amanda Feyerabend
afeyerabend@compensia.com
415.462.2988

Greg Loehmann
gloehmann@compensia.com
408.907.4319

Southern California

Ralph Barry
rbarry@compensia.com
858.603.2288

Mathew T. Quarles
mquarles@compensia.com
323.919.7338