EFiled: Dec 23 2011 4:30PM EST
Transaction ID 41561039
Case No. 6462-VCG

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

FRANK DAVID SEINFELD, Plaintiff, v. DONALD W. SLAGER, JAMES E. O'CONNOR JOHN W. CROGHAN, TOD C. HOLMES, DAVID I. FOLEY, RAMON A. RODRIGUEZ, MICHAEL W. WICKHAM, JAMES W. CROWNOVER, NOLAN LEHMANN, ALLAN C. CORENSEN, WILLIAM J. FLYNN, W. LEE NUTTER, JOHN M. TRANI, MICHAEL LARSON and REPUBLIC SERVICES, INC., Defendants.	:	Civil Action: 6462-VCG

<u>BRIEF IN OPPOSITION TO DEFENDANTS' MOTION TO DISMISS</u>

BIGGS and BATTAGLIA
Robert D. Goldberg (I.D. No. 631)
921 North Orange Street
Wilmington, DE 19899
Tel: 302-655-9677
goldberg@batlaw.com

Attorneys for Plaintiff

Of Counsel:

BARRACK, RODOS & BACINE
Alexander Arnold Gershon
Michael A. Toomey
425 Park Ave., 31st Floor
New York, NY 10022
(212) 688-0782

BARRACK, RODOS & BACINE
Daniel E. Bacine
Two Commerce Square
2001 Market Street – Suite 3300
Philadelphia, PA 19103
(215) 963-0600

December 23, 2011

TABLE OF CONTENTS

TABLE OF CITATIONS

Cases

Statutes

Other Authorities

Regulations

Rules

Plaintiff, by and through his counsel, respectfully submits this brief in opposition to defendants' motion to dismiss.

STATEMENT OF THE NATURE AND STAGE OF THE PROCEEDING

This is a stockholder's derivative action on behalf of Republic Services, Inc. ("Republic" or the "Company"), a Delaware corporation, challenging the authorization and payment of several excessive compensation awards to senior officers and directors of Republic. These payments have wasted Company assets by violating shareholder-approved compensation plans while unjustly enriching senior officers and directors of Republic. Plaintiff alleges that these actions make out claims for breach of fiduciary duty, waste, and unjust enrichment against defendants Slager, O'Connor, Croghan, Holmes, Foley, Rodriguez, Wickham, Crownover, Lehmann, Sorensen, Flynn, Nutter, Trani and Larson (the "Individual Defendants"). On May 9, 2011, when the original complaint in this action was filed, defendants Slager, O'Connor, Croghan, Foley, Rodriguez, Wickham, Crownover, Lehmann, Sorensen, Flynn, Nutter, Trani and Larson constituted Republic's board of directors (the "Board"). Defendants O'Connor, Holmes, and Slager were employees of Republic at that time. Plaintiff filed the Amended Stockholder's Derivative Complaint (the "Complaint") on August 25, 2011. The Company and the Individual Defendants moved to dismiss the Complaint on October 12, 2011.

STATEMENT OF FACTS

I. REPUBLIC'S CULTURE OF EXCESSIVE COMPENSATION

In their opening brief defendants state, "Jim O'Connor was Republic's Chairman and CEO for nearly a decade. . . ." Defendants' Opening Brief in Support of Defendants' Motions to Dismiss the Amended Derivative Complaint ("Defs.' Br.") at 6. Defendants fail to mention that over this decade defendant O'Connor has maintained a culture that rewards executives with excessive compensation that is disproportionate to performance to the detriment of shareholders. The Complaint alleges recent fiduciary violations that are representative of this deficient environment; however, for the court to appreciate these allegations, this tradition of misfeasance merits further examination:

While employed as CEO of Republic, defendant O'Connor maintained extraordinary control over his own compensation. Indeed, during his entire tenure O'Connor recommended his own performance goals and evaluated his performance with regard to those goals:

> The [c]ompensation [c]ommittee meets annually with the CEO to receive his recommendations concerning [his annual and long-term performance] goals. The chair of the [c]ompensation [c]ommittee then meets with the CEO to evaluate his or her performance against such goals.

Plaintiff's Exhibit ("Pl.'s Ex.") 1 (Republic 2004 proxy statement) at A-5 (Republic's Corporate Governance Guidelines, last disclosed in 2004); *see also* Pl.'s Ex. 2 (Republic's website indicates that this process has never been modified).

And, until Republic was forced to disclose this in 2007, O'Connor *recommended his own compensation*. Republic revealed this information grudgingly, only telling shareholders that "Beginning in 2007, the Compensation Committee has requested that the Chief Executive Officer no longer make any recommendation regarding his compensation." Pl.'s Ex. 3 (Republic 2007 proxy statement) at 10. That shareholders were never previously informed that O'Connor had this power was not revealed. Instead, Republic made this revelation appear to be an act of goodwill – an expression that shareholders were already aware of this fact, but that now Republic wished to restrict O'Connor's influence. However, goodwill did not compel this disclosure; the Securities & Exchange Commission (the "SEC") required it when the SEC modified its proxy disclosure requirements five months earlier on November 7, 2006. Executive Compensation and Related Person Disclosure, Securities Act Release Nos. 33-8732A; 34-54302A; IC-27444A, 71

Fed. Reg. 53,158, 53,164-65, 53,242 (Sept. 8, 2006) (Regulation S-K, 17 C.F.R. 229.402 (2011) was modified to require disclosure of "(v) How the registrant determines that amount . . . for each element to pay [and] . . . (xv) The role of executive officers in determining executive compensation"). When Republic was required to disclose this policy, the policy was immediately changed to make it appear that Republic was responsive to shareholder concerns rather than afraid of shareholder retribution.

The above conduct has been called into question by industry watchdogs. For example, in June 2009, Audit Integrity, a research firm specializing in corporate risk management, added Republic to its "Investor WatchList" for companies that "hav[e] the greatest short-term equity risk." Pl.'s Ex. 4 (Audit Integrity Investor WatchList). Not long after, Audit Integrity placed Republic Services on a "very short list" of ten companies that had similar governance characteristics to a company that had recently disclosed accounting fraud. Pl.'s Ex. 5 (James A. Kaplan, *Another Reason for Corporate Fraud: "We Like Stealing"*, Sept. 14, 2009). Audit Integrity stated the list's intent was "to ferret out similar potential disasters." *Id.*

II. PLAINTIFF'S ALLEGATIONS

Having constructed this deficient corporate environment, on January 1, 2011, defendant O'Connor voluntarily retired from Republic. As he explained in a press release,

> "I believe the time is right for me to retire . . . . It is with pride and confidence that we prepare to transition leadership of the company into the capable hands of Don Slager, who I believe is the ideal person to lead the next chapter in Republic's history."

Pl.'s Ex. 6 (*Republic CEO to Retire at Start of 2011*, PENTON BUS. MEDIA, June 29, 2010). Over the previous decade O'Connor received $28,954,831 in cash compensation. Pl.'s Ex. 7 (Republic 2002 Proxy Statement) at 10; Pl.'s Ex. 8 (Republic 2003 Proxy Statement) at 10; Pl.'s Ex. 1 (Republic 2004 Proxy Statement) at 12; Pl.'s Ex. 9 (Republic 2005 Proxy Statement) at 13;

Pl.'s Ex. 10 (Republic 2006 Proxy Statement) at 13; Pl.'s Ex. 3 (Republic 2007 Proxy Statement) at 19; Pl.'s Ex. 11 (Republic 2008 Proxy Statement) at 19; Defendants' Exhibit Filed with Defendants' Motion to Dismiss ("Defs.' Ex.") F (Republic 2009 Proxy Statement) at 30; Pl.'s Ex. 12 (Republic 2010 Proxy Statement) at 36; Pl.'s Ex. 13 (Republic 2011 Proxy Statement) at 37.

O'Connor was also given tens of millions of dollars more in various equity compensation, benefits and perquisites. *Id.* In addition, although as of 2008 O'Connor could only be provided $2,894,515 upon retirement, a new employment agreement ("O'Connor's Employment Agreement") effective as of December 5, 2008, Defs'. Ex. B (O'Connor's Employment Agreement) at 1, increased this amount ten-fold to $21,473,634 by the end of 2009. *Compare* Defs' Ex. F at 43 *with* Pl.'s Ex. 12 at 55. The following year, on or about June 25, 2010, O'Connor signed a retirement agreement ("O'Connor's Retirement Agreement"), *see* Defs.' Ex. C (O'Connor's Retirement Agreement) at 5, that again increased this compensation to $22,088,589 according to Republic's 2011 proxy statement. Pl.'s Ex. 13 at 58. However, even this incredibly high retirement compensation did not include several additional payments guaranteed by O'Connor's Retirement Agreement, as described below. When these additional payments are included, O'Connor was given nearly $39,000,000 in return for the act of leaving Republic permanently.

A. O'Connor's $1,800,000 Gift "For Your Long Service to the Company"

Among many other awards, O'Connor's Retirement Agreement gave him a "lump sum cash retirement payment of $1,800,000 . . . for [his] long service to the Company." For reasons that Republic has not explained, this amount was not included within the $22,088,589 described to shareholders as his "Post-Employment Compensation – Retirement." *Compare* Defs.' Ex. C at 3 *with* Pl.'s Ex. 13 at 58. The complaint alleges that this is compensation for past services and therefore is waste. Compl. ¶ 27.

B. "Synergy" Bonuses

In addition to the $22,088,589 retirement compensation and $1,800,000 gift, O'Connor's Retirement Agreement also guaranteed that he would "remain eligible to receive [his] Synergy Bonus in the maximum amount of $15,000,000." Defs.' Ex. C. at 1. Altogether then, O'Connor could be paid as much as $38,888,589 after retirement. This "Synergy Bonus" was also not included in the calculation of his retirement compensation. *See* Pl.'s Ex. 13 at 58.

The Complaint alleged that payments to O'Connor and other executives of up to $69 million in "Synergy Bonus[es]" is wasteful because the goals set for the Synergy Incentive Plan (the "Synergy Plan") are illusory. Compl. ¶¶ 38-40. The Synergy Plan is a shareholder-approved plan that was supposed to pay incentive bonuses to "[s]elected executives and key managers . . . based on the degree to which targeted Synergies . . . are generated following the merger of Republic Services and Allied Waste [Industries, Inc. ('Allied')]." Defs.' Ex. G at B-1 § I ¶ A.

In plaintiff's federal court action, plaintiff alleged that "the 'performance goals' used to determine whether a Synergy bonus is payable are too numerous and complicated." Pl.'s Ex. 14 (defendants' federal brief) at 9. Defendants' responded, "[P]laintiff mischaracterizes the Synergy Plan. There is only one goal: *measurable earnings improvement* over baseline through cost improvements as a result of the integration of the two predecessor companies." *Id.* (emphasis added). As such, in composing the instant Complaint, plaintiff argued that there was no "measureable earnings improvement" because Republic's earnings from 2009, 2010 and the first nine months of 2008 were less than the combined earnings of Republic and Allied in 2007. Compl. ¶ 40.

But now, in this state court action, defendants claim that the Synergy Plan

> has nothing to do with the Company's total earnings. Rather that target is defined in terms of cost improvement from particular synergy initiatives, which will be "*measured based upon the incremental and ongoing impact to EBIT* [(earnings before interest and taxes)] attributable to the combination of Republic and Allied."

Defs.' Br. at 11 (quoting Defs.' Ex. G at B-1 § IV ¶ A) (emphasis added).

However, as with Republic's total earnings, Republic's EBIT also fails to show any improvement since the acquisition of Allied. The Synergy Plan claimed,

> More specifically, synergy impact is *any incremental and ongoing impact to EBIT attributable to the combination of Republic and Allied*. EBIT impact will be *measured over the baseline which includes the operations of the two businesses standalone*. Synergy will be the net impact of incremental positive and negative impacts to EBIT associated with company integration.

Id. at B-6 (emphasis added).

Republic does not report its "EBIT" on its financial statements, but it does report its "operating income" and "earnings before interest and taxes (EBIT) [is] frequently referred to as operating income." Pl.'s Ex. 15 (Israel Shaked and Allen Michel, *Value & Cents: Valuing the Financially Distressed Firm*, 18-3 AM. BANKR. INST. J. 34 (Apr. 1999)); *see also* Pl.'s Ex. 16 (John Yozzo, Kevin Regan & Don May Ph. D., *Return on Assets: So Useful . . . and So Misused*, 20-9 AM. BANKR. INST. J. 18 (Nov. 2001)) (PricewaterhouseCoopers employees using "Operating profit" and "EBIT" interchangeably); *see also* Pl.'s Ex. 17 (Peter V. Pantaleo and Barry W. Ridings, *Reorganization Value*, 51 BUS. LAW. 419, 419 n.a1, 422 n.12 (Feb. 1996)) (authors explain that "'EBIT' – earnings before interest and taxes – usually measures operating income" after thanking "Thomas L. Ambro, a member of Richards Layton & Finger . . . for [his] helpful comments on drafts of this Article").

Therefore, in order to determine the "baseline [EBIT] which includes the operations of the two businesses standalone" it is only necessary to add together the "operating income" of each company for 2007, the last full year before the acquisition of Allied. For 2007, Republic reported an "operating income" of $536 million, Pl.'s Ex. 18 (Republic 2010 10-K) at 33, and Allied reported an "operating income" of $1,055.7 million. Pl.'s Ex. 19 (Allied 2007 10-K) at 27. Therefore, the "baseline [EBIT] which includes the operations of the two businesses standalone" is $1,591.7 million. As with Republic's earnings figures, Republic's EBIT – operating income – has never surpassed this baseline measure since the acquisition. *See* Pl.'s Ex. 18 (2010 10-K) ("Operating Income . . . 1,539.1 [million for 2010;] 1,589.8 [million for 2009]) at 33). As such, Republic has never had any "impact . . . measured over the baseline" EBIT, and since there has been no "incremental positive . . . impact," there has been no "Synergy." *See* Defs.' Ex. G at B-6.

Despite the fact that there is no "Synergy" as measured by EBIT or total earnings, Republic declared in its 2011 proxy statement that "[d]uring 2010, we completed the integration of Allied operations resulting in approximately *$190 million of annual run-rate synergy savings*, exceeding our original estimate of approximately $150 million by 26.7%." Pl.'s Ex. 13 at 25 (emphasis added). In addition, very recently Republic disclosed that they have booked $68.1 million in liabilities due to the Synergy Plan. Pl.'s Ex. 26 (Republic 2011 first quarter 10-Q) at10. This figure is barely less than the $69 million "total maximum awards" Republic could have approved under the Synergy Plan for defendants O'Connor, Slager and Holmes, among others. Defs.' Ex. G at B-1 § II ¶ C. Therefore, although these "payments . . . will [not] be made [until] after December 31, 2011" as required by the Synergy Plan, *Id.* at B-2 § VI ¶ B, the liability for these payments has already been accounted for. Plaintiff alleges that these payments totaling $68.1 million are wasteful because they are not attributable to any measurable performance, as the Synergy Plan required.

C. O'Connor's $1,250,000 "Incentive" Payment That "Ha[s] Not Been Determined to Have Been Earned"

O'Connor's Retirement Agreement also guaranteed that "[n]o sooner than the sixth month anniversary of your [r]etirement [d]ate and no later than December 31, 2011, the Company shall pay [O'Connor] the amount of [his] long term incentive award for 2009-2011." Defs.' Ex. C at 2. The Complaint alleged that the "amount" of this payment was wasteful because it paid him the full amount of this "performance" award despite the fact that he did not meet the performance standards for the 2009-11 performance period. Compl. ¶ 23

"[T]he amount of [O'Connor's] long term incentive award for 2009-2011" had previously been decided in O'Connor Employment Agreement:

> For purposes of this [a]greement, . . . all [l]ong [t]erm [a]wards . . . to be fully vested . . . shall include . . . [a]wards which have been granted to [e]mployee . . . which, as of the date of his retirement, *have not been determined to have been earned pursuant to the Plan* . . . (x) for award periods beginning on or before January 1, 2009, *the full target amount* that . . . was authorized to cause to be paid to [O'Connor] pursuant to the Executive Incentive Plan, ...

Defs.' Ex. B at 20 ¶ 25 (emphasis added). The Executive Incentive Plan (the "EIP") is Republic's cash incentive plan that paid certain executive officers cash bonuses for ostensibly meeting or exceeding performance goals measured by the Company's financial results. Defs.' Ex. I at A-3 – A-5; Compl. ¶ 11. Defendant O'Connor was an EIP "participant" for the years 2009 and 2010. Defs.' Ex. F at 47 ("[p]articipation in the [EIP] will be limited to the following categories of employees: the chief executive officer . . ."). Defendants Slager and Holmes were also participants in the EIP. Compl. ¶ 23.

Plaintiff alleged that this payment was non-deductible under I.R.C. § 162(m) (2006) ("§ 162(m)") and was hidden from stockholders and that therefore this payments is not tax-deductible. Compl. ¶¶ 11-24. In addition, the Complaint also alleged that because of this payment the entire EIP is not tax-deductible under § 162(m). Compl. ¶ 23. Plaintiff alleges that this single payment is wasteful because it has cost and will cost Republic millions of dollars in tax deductions.

D. Equity Payments That Did Not Address Performance

O'Connor's retirement agreement also guaranteed that "[a]ll of your stock option, restricted stock and restricted stock unit awards that are outstanding as of your Retirement Date shall fully vest upon your Retirement Date and your termination shall be treated as retirement for purposes of such awards." Defs.' Ex. C at 2. Many, if not all of these equity awards were made under Republic's 2007 Stock Incentive Plan (the "Stock Plan").

The Complaint alleged that those awards that were granted to O'Connor and other employees under the Stock Plan, including defendants Slager and Holmes, were wasteful because the excessive quantity of non-tax-deductible awards of restricted stock and restricted stock units made under the Stock Plan were unusual and contrary to the express provisions of the plan. Compl. ¶¶ 29-33.

Defendants do not argue that any of the restricted stock awards that were granted to Covered Employees were tax-deductible under § 162(m). Defs.' Br. at 8-9. Therefore, in three years, non-tax-deductible awards under the Stock Plan have been paid out totaling $14,982,384. Defs.' Ex. F at 32; Pl.'s Ex. 12 at 38; Pl.'s Ex. 13 at 39. As the Complaint noted, these payments constituted 25% - 65% of the CEO and four other most highly-compensated employees' salaries. Compl. ¶ 30; *see also* Pl.'s Ex. 13 at 37.

The Complaint alleged that these awards were wasteful because it is unusual for a corporation to pay so much non-tax-deductible compensation. Compl. ¶ 32. To demonstrate how unusual Republic's waste is, the Complaint named three members of Republic's peer group who provide nearly all of their equity compensation so that it is tax-deductible under § 162(m). *Id.*

Waste Management Inc. pays out all of its equity compensation either as stock options or restricted stock tied to "the achievement of performance criteria." Pl.'s Ex. 20 (Waste Management Inc. 2011 proxy statement) at 39 n.2. Norfolk Southern Corp. only provides stock options or equity compensation that is "based on [its] performance during [the previous] three-year period. Pl.'s Ex. 21 (Norfolk Southern Corp. 2011 proxy statement) 41, 43 n.5 & n.6, 44. In addition, CSX Corp. provides two-thirds of its equity compensation "based on preestablished financial performance and strategic goals." Pl.'s Ex. 22 (CSX Corp. 2011 proxy statement) at 42 n.2, 31. That Republic does not follow the lead of these peer companies is odd because its proxy statements claim it uses the above three companies' "compensation programs . . . as context in establishing the structure and levels of compensation for our named executive officers. . . ." Pl.'s Ex. 13 at 33-34.

Plaintiff also alleged that the above non-tax-deductible payments constituted waste because they were granted contrary to the Stock Plan's express provision that

> [t]he purpose of the [Stock] Plan is to enable the Company to attract, retain, reward and motivate [e]ligible [i]ndividuals by providing them with an opportunity to acquire or increase a proprietary interest in Republic and to *incentivize them to expend maximum effort* for the growth and success of the Company, so as to strengthen the mutuality of the interests between the [e]ligible [i]ndividuals and the shareholders of Republic.

Defs.' Ex. D at A-1; Compl. ¶ 31. But none of the non-tax-deductible awards "incentivize . . . maximum effort" because they do not reward actual performance. As plaintiff alleged, these awards were "unusual" because the purpose of the Stock Plan is to align the interest of [participants] with those of the Company's stockholders," but these time-based awards simply encouraged participants to show up to work. Compl. ¶ 31. The Stock Plan invited Republic to incentivize effort – restricted stock awards *could* have been provided based on actual achievement or they could be provided capriciously. Defs.' Ex. D at A-12 ¶ (b) ("[t]he [Compensation] Committee shall impose such restrictions on any Restricted Stock granted pursuant to the [Stock Plan] as it may deem advisable including . . . the attainment of Performance Goals"). Unfortunately, the Stock Plan requirement to incentivize performance was ignored because no payments of "restricted stock" were made contingent on actual performance. Plaintiff alleges this was wasteful and contrary to the terms of the plan.

E. Excessive Non-Employee Director Compensation

Republic's tradition of overpaying did not end with executive compensation. As the Complaint alleges, the non-employee Board members were provided with extraordinary compensation for at least 2009 and 2010. Compl. ¶¶ 34-35. In 2010, the Board awarded the Director Defendants, except O'Connor, $215,000 each in restricted stock units, which brought their annual compensation to between $320,000 and $345,000 each. Pl.'s Ex. 13 at 18. In 2009, the Board awarded the Director Defendants, except O'Connor and Larson, a one-time payment of 22,500 restricted stock units valued at $24.79 each (totaling $557,775 per director), which brought their annual compensation to between $843,200 and $891,700 each. Defs.' Ex. E at 17. The annual compensation of the Republic directors far exceeds the annual compensation of the

Waste Management directors of between $205,000 and $240,000, except for the non-executive chairman of the board, who was paid $422,000 in 2010. Pl.'s Ex. 20 at 13.

The Complaint alleges that this compensation is excessive and unusual, and, consequently, that this compensation is wasteful. Compl. ¶ 35.

STATEMENT OF THE QUESTIONS INVOLVED

(1) Is it a breach of a stockholder-approved compensation plan to pay out compensation under the plan that does not follow its terms?

(2) Is it wasteful for a public corporation to provide its chief executive officer $1,800,000 on his voluntary retirement for past services when it has already agreed to pay him up to almost $39 million after retirement?

(3) Is it wasteful for a public corporation to pay maximum compensation under a stockholder-approved plan whose goals have not been met?

(4) Is it wasteful to lose millions of dollars in tax deductions so that a single employee can be paid hundreds of thousands of dollars that he did not earn?

(5) Is it wasteful to lose millions of dollars in tax deductions so that employees can be paid compensation that does not follow the terms of stockholder-approved plans?

(6) Is it unusual and wasteful to give non-employee directors a one-time award valued at $557,775 and other compensation that far exceeds the compensation of peer group companies?

(7) Is it unusual and wasteful to pay millions in non-tax-deductible, non-performance-based compensation under a stockholder-approved plan that is intended to incentivize performance?

ARGUMENT

Defendants attempt to dismiss plaintiff's allegations under DEL. CH. CT. R. 12(b)(6) "for failure to state a claim" and DEL. CH. CT. R. 23.1(a) for failure to "allege with particularity the ... the reasons for the plaintiff's failure to" make a demand upon Republic's Board.

As to defendants' 12(b)(6) motion, plaintiff has properly stated a cause of action for each of above described allegations. Recently, the Delaware Supreme Court reaffirmed Delaware's 12(b)(6) motion to dismiss standard, which states that the court should "deny the motion unless the plaintiff could not recover under any *reasonably conceivable* set of circumstances susceptible of proof." *Central Mortgage Co. v. Morgan Stanley Mortgage Capital Holdings*, 27 A.3d 531, 536 (2011) (emphasis added). This standard of review is less demanding on plaintiff than the federal "plausibility" standard delineated in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 556 (U.S. 2007). *Central Mortgage Co.*, 27 A.3d at 537. As demonstrated below, all of plaintiff's allegations easily survive a "reasonably conceivable" analysis because they are all supported by Republic's public disclosures and Delaware law.

Defendants' motion under R. 23.1(a) is equally unavailing. Plaintiff has not made a demand here because it is futile and because "Delaware law . . . substantially alters the nature of a derivative plaintiff's claim where demand has been made and conversely gives shareholders considering litigation good reason not to make a demand." *RCM Securities Fund, Inc. v. Stanton*, 928 F.2d 1318, 1328 (2d Cir. 1991). This is because when demand is made in a derivative case based on Delaware law it substantially weakens the claim:

> If no demand is made, the derivative action may challenge the underlying transaction, and the complaint will not be dismissed because of the business judgment rule if it has alleged a prima facie breach of a fiduciary obligation. Once a demand is made, however, the challenge under Delaware law must be not to the underlying transaction, but to the board's decision not to bring the lawsuit.

> … If reported cases are any indication, few, if any, plaintiffs surmount this obstacle.

Id. (citing *Spiegel v. Buntrock*, 571 A.2d 767, 775, 777 (1990)). This is why "stockholders often do not make a demand on the board of directors, and instead file suit claiming that demand is excused" in cases where the complaint alleges "misconduct by . . . directors," *Rales v. Blasband*, 634 A.2d 927, 933 (1993) (quoting *Aronson v. Lewis*, 473 A.2d 805, 811 (1984)). Consequently, because, as shown below, demand is futile in this matter and because making demand would weaken plaintiff's case and change the analysis of this court, plaintiff has not made a demand.

I. PLAINTIFF HAS PROPERLY STATED CAUSES OF ACTIONS FOR BREACH OF FIDUCIARY DUTY, WASTE AND UNJUST ENRICHMENT BECAUSE DEFENDANTS VIOLATED SHAREHOLDER-APPROVED PLANS

Under Delaware law, stockholder-approved incentive compensation plans, such as the EIP (which includes the Synergy Plan) and the Stock Plan are "contract[s] between . . . shareholders (which includes plaintiff[]), on one hand, and the defendant board of directors (which includes the management Participants), on the other." *Sanders v. Wang*, 24 Employee Benefits Cas. (BNA) 1924, 1999 Del. Ch. LEXIS 203, at *21 (Del. Ch. 1999); *see also Ryan v. Gifford*, 918 A.2d 341, 358 (Del. Ch. 2007). As such, "the board has no discretion to contravene the terms of [these plans]." *Ryan*, 918 A.2d at 354. Despite this, defendants committed "clear violation[s] of . . . specific provision[s] of the contract[s]. *Sanders*, 1999 Del. Ch. LEXIS 203, at *21. With regard to the Synergy Plan, defendants have accounted for Synergy Plan payments when no "synergy" has been accomplished. With regard to the Stock Plan, defendants failed to tie any compensation paid under it to performance, as was required by the plan.

A. Defendants Breached the Synergy Plan by Determining Synergy Bonuses That Were Not Merited

When shareholders approved the EIP, they also approved the "Synergy Award." Defs.' Ex. I at A-1 § 2. According to the EIP, the "Synergy Award" would be paid "pursuant to the terms of the ['Synergy Program']." *Id.* at A-4 § 4.2. The terms of the "Synergy Program" are found in the Synergy Plan, which were provided to shareholders immediately following the EIP on the 2009 proxy statement. Therefore, the terms of the Synergy Plan were approved by shareholders when they approved the EIP.

As such, the Synergy Plan constitutes a "contract . . . between . . . shareholders (which includes plaintiff[]), on one hand, and the defendant board of directors (which includes the management Participants), on the other." *Sanders*, 1999 Del. Ch. LEXIS 203, at *21. To this end, when the Compensation Committee violated the terms of the Synergy Plan by accounting for $68.1 million in compensation under the Synergy Plan, Pl.'s Ex. 26 at 10, defendants violated the terms of the Synergy Plan because, according to the Synergy Plan, "synergy impact is any incremental and ongoing impact to EBIT attributable to the combination of Republic and Allied. EBIT impact will be measured over the baseline which includes the operations of the two businesses standalone." Defs.' Ex. G at B-1. And, as noted above, there has been no increase to EBIT (or earnings) since the Synergy Plan was created. Therefore, the Compensation Committee's assessment of $190 million in synergies under the Synergy Plan violates the terms of the stockholder-approved Synergy Plan. Pl.'s Ex. 13 at 25.

This Court has stated that "[h]aving concluded . . . that the board exceeded its authority" with regard to a shareholder-approved compensation plan, such allegations make out claims for breach of fiduciary duty, waste and unjust enrichment:

> For a *waste* claim to survive a motion to dismiss, the plaintiff must allege facts sufficient to show that the corporation received no consideration for the transferred asset. The standard is stringent and requires that no person of ordinary business judgment would conclude that the deal was fair to the corporation. It is my view that the alleged acts, drawing all inferences in plaintiffs' favor raise sufficient question[s] . . . to state a claim of *breach of fiduciary duty* and for this Court to deny the defendants' motion to dismiss . . . . [T]he alleged acts clearly call into question whether the transaction as consummated could have benefited [the company] and whether the breach of fiduciary duty caused corporate officers to be *unjustly enriched*.

Sanders v. Wang, 1999 Del. Ch. LEXIS 203, at *31-*32 (emphasis added); *see also Ryan*, 918 A.2d at 361. Thus, these claims should survive this motion to dismiss.

B. Defendants Breached the Stock Plan by Making Equity Payments that Failed to Reward Performance

When the Stock Plan was presented for stockholder-approval, the plan stated that one of its purposes is "to incentivize [Eligible Individuals] to expend maximum effort for the growth and success of the Company." Defs.' Ex. D. at A-1. Despite this unambiguous language, to date the Stock Plan has never maximized effort because "[t]he restricted stock and restricted stock units we grant to our executive officers . . . vest over time rather than based on performance." Defs.' Ex. E at 33. Having properly alleged that defendants have violated the terms of the LTIP and that defendants have paid out compensation as a result of these violations, plaintiff has also properly alleged claims for breach of duty of loyalty, waste and unjust enrichment. *Sanders,* 1999 Del. Ch. LEXIS 203, at *32-*41; *see also Ryan*, 918 A.2d at 357-61.

II. PLAINTIFF HAS PROPERLY STATED CAUSES OF ACTIONS FOR WASTE AND UNJUST ENRICHMENT FOR O'CONNOR'S $1,800,000 GIFT AND SYNERGY PLAN PAYMENTS

The Delaware Supreme Court has defined waste as "'a transfer of corporate assets . . . for which no consideration at all is received . . . in effect a gift.'" *Brehm v. Eisner,* 746 A.2d 244, 263 (2000) (quoting *Lewis v. Vogelstein*, 699 A.2d 328, 336 (Del. Ch. 1997)). Under this standard, the Compensation Committee's payment of $1,800,000 to O'Connor "for [his] long service to the Company" and the Synergy Bonuses of $68.1 million constitute waste because no consideration has been received for either of them.

A. Republic's Gift of $1,800,000 to O'Connor Is Waste

An agreement to pay compensation for past services "constitutes an illegal gift of corporate assets." *Fidanque v. Amer. Maracaibo Co.*, 92 A.2d 311, 320-21 (Del. Ch. 1952). Here, defendants provided such a gift when they agree to pay O'Connor $1,800,000 "for [his] long service to the Company." Defs.' Ex. C at 3. In response, defendants argue (1) that Republic did receive consideration for this $1,800,000 and (2) that even if Republic did not receive such consideration the "amount awarded is not unreasonable in view of the services rendered." Defs.' Br. 22-24 (quoting *Blish v. Thompson Automatic Arms Corp.*, 64 A.2d 581, 589 (1948)).

Defendants argue that Republic received consideration for this $1,800,000 because "[u]nder the terms of his 2009 Employment Agreement, Mr. O'Connor controlled his retirement date . . . [And in exchange for O'Connor's Retirement Agreement] Mr. O'Connor agreed to set a retirement date six months in the future and to remain on the Board as Chairman until the May 2011 Annual Meeting." Defs.' Br. at 22-23. There are several reasons, however, why Republic received no such consideration.

In the first place, defendants are factually mistaken – O'Connor did not control his retirement date under the 2009 Employment Agreement. Prior to signing O'Connor's Retirement Agreement, O'Connor was actually required to give "12 months advance notice of retirement" to receive any retirement payments under O'Connor's Employment Agreement.

Defs.’ Ex. B at 19 ¶ 25. Thus, Republic actually lost six months of transition time when O’Connor’s Retirement Agreement was signed.

Moreover, Republic was explicit that the $1,800,000 was being provided “for your long service to the Company” and for no other reason. Defs.’ Ex. C at 3. Therefore, by O’Connor’s Retirement Agreement’s clear and unambiguous terms the reason for this award was simply past performance. *Hajoca Corp. v. Security Trust Co.*, 25 A.2d 378, 383 (1942) (“it is the duty of the Court to construe contracts as they are made by the parties themselves, and to give to language that is clear, simple and unambiguous the force and effect which the language clearly demands. The Court cannot assume to make for the parties a better agreement than they themselves have been satisfied to make . . . .”). This legal concept is reinforced by the fact that O’Connor’s Retirement Agreement required that each individual term be separately enforceable. Defs.’ Ex. C. at 4 (“[i]f a court of competent jurisdiction determines that any of the provisions of this [a]greement are invalid or legally unenforceable, all other provisions of this [a]greement shall not be affected and are still enforceable”).

Defendants also argue that “retroactive compensation is permissible even without any new consideration when ‘the amount awarded is not unreasonable in view of the services rendered.’” Defs.’ Br. at 24 (quoting *Blish*, 64 A.2d at 589). Defendants are correct that in some exceptional instances where defendants are able to show with the evidence before the court that the “services rendered [are] unusual in character and extraordinary” compensation for past services is proper despite the general rule. *Blish*, 64 A.2d at 589.

In this case, however, defendants haven’t even attempted such a showing. Instead, defendants claim, without providing any support, that it is plaintiff’s burden to demonstrate that this exception *does not apply* to the current situation. Defs.’ Br. at 24. This is an odd claim given that plaintiff's burden at this stage is merely to provide sufficient information to show he could "recover under any *reasonably conceivable* set of circumstances susceptible of proof." *Central Mortgage Co.*, 2011 Del. Lexis 439, at *13 (emphasis added).

None of the cases defendants cite suggest that the burden lies with the plaintiff. In *Blish*, for example, the court had the benefit of several "depositions taken in the cause and admitted, and . . . evidence taken in the cause and exhibits offered by the respective parties and admitted by the Chancellor." *Blish*, 64 A.2d at 593. Based upon this copious evidence, the court was able to find that the challenged compensation was being paid to an employee who

> largely because of his business acumen and constant efforts, the joint enterprises … within the space of two and one-half years sprung from the steps of poverty to a successful and internationally known arms corporation. . . such results in our opinion standing alone completely justify the [increased] salary and tax reserves paid . . . .

Id. at 606. In *Zupnick v. Goizueta*, 698 A.2d 384, 388 (Del. Ch. 1997), the court also held that the exception applied to compensation for past services, but only because *defendants made it clear in their 1996 proxy statement* that the compensation was being paid based on "'the remarkable increase in market value of the [c]ompany during [his tenure] (nearly $69 billion).'" *Id.* at 385, 388. Here, defendants have failed to point to any such extraordinary facts that would justify disregarding a general rule of contract law. That is because such comparable facts do not exist.

Here, O'Connor received $28,954,831 in cash compensation over the previous decade and tens of millions of dollars more in various equity compensation, benefits and perquisites. In addition, between 2008 and 2010 his retirement compensation increased ten-fold to $22,088,589 according to Republic's 2011 proxy staetment. Pl.'s Ex. 13 at 58. Moreover, he was entitled to, and according to Republic's filings he will receive, nearly $15 million in compensation for his

"Synergy Award." However, all of this compensation did not include the $1,800,000 he received "for [his] long service to the Company." Plaintiff alleges that this payment is at best compensation for past services, and the lack of any extraordinary reason for it means that such compensation is waste. In essence, this $1,800,000 was O'Connor's ridiculously expensive gold watch.

B. Republic's Payments under the Synergy Plan Are Gifts

Similarly, Republic's promised payments of $68.1 million under the Synergy Plan are also "'a transfer of corporate assets . . . for which no consideration at all is received . . . in effect a gift.'" *Brehm*, 746 A.2d at 263 (quoting *Vogelstein*, 699 A.2d at 336). As demonstrated above, the Synergy Plan has generated no synergy; therefore any payments made under it are made in return for nothing. They are gifts.

III. PLAINTIFF HAS PROPERLY STATED CAUSES OF ACTIONS FOR WASTE AND UNJUST ENRICHMENT DUE TO REPUBLIC'S LOSS OF TAX DEDUCTIONS UNDER THE EIP, STOCK PLAN, AND SYNERGY PLAN

Plaintiff alleged that defendants failure to follow the terms of the EIP, Stock Plan, and Synergy Plan means that compensation paid out under these plans cannot be tax-deductible under § 162(m). Compl. ¶¶ 23, 30-31, 48. Therefore, compensation provided to Republic's CEO and four other highest paid employees under these plans is not tax-deductible in excess of $1 million. § 162(m)(1). This compensation is not deductible because it will not be "payable solely on account of the attainment of one or more performance goals" "the material terms [of which having been] disclosed to shareholders and approved by a majority of the vote." § 162(m)(4)(C)(ii). The Complaint alleges the loss of these tax deductions is waste. Compl. ¶¶ 23, 30-31, 48.

In Delaware, "[t]he common law imposes fiduciary duties upon the directors of Delaware corporations to constrain their conduct when" managing the business for the benefit of the stockholders. *Seinfeld v. Verizon Commc'ns., Inc.*, 909 A.2d 117, 119 (2005). In various areas of the law, courts and commentators have determined that fiduciaries have a duty to minimize taxes. *See Clark v. U.S.*, 587 F.2d 465, 468-89 (10th Cir. 1978) (U.S. arguably committed a "serious breach of . . . fiduciary duty" in not seeking a tax refund for its principal); *Estate of Estes v. Valley Nat'l Bank*, 654 P.2d 4, 10 (Ariz. App. 1982) (executor has an "obligation to minimize estate taxes"); Pl.'s Ex. 23 (Mark L. Ascher, *The Fiduciary Duty to Minimize Taxes*, 20 REAL PROP. PROB. & TR. J. 663, 664 (Summer 1985)) (in trusts and estates, if a fiduciary causes his entity to overpay its taxes, he is generally personally liable to the entity for the excess tax).

Likewise, although there is a paucity of case law on the subject, four courts that have addressed derivative suits regarding corporate overpayment of taxes have held corporate boards have a duty to minimize them. *Dodge v. Woolsey*, 59 U.S. 331 (U.S. 1856); *Truncale v. Univeral Pictures Co.*, 76 F. Supp. 465 (S.D.N.Y 1984); *Spirt v. Bechtel*, 232 F.2d 241 (2d Cir. 1956); *Resnik v. Woertz*, 774 F. Supp. 2d 614 (D. Del. 2011).

In *Dodge*, a stockholder brought a derivative action to enjoin the board from paying, and Ohio from collecting, an allegedly unlawful tax. *Dodge*, 59 U.S. 331. This tax was constructed by Ohio under its new constitution, which allowed the state to tax banks' income. *Id.* at 337-40. The stockholder argued that this tax could not be applied to the bank, which was incorporated under the previous constitution, and that the board of directors had a duty to fight it. *Id.* at 344-45. The Supreme Court of the United States agreed this duty existed, stating,

> [T]he refusal upon the part of the directors . . . partakes more of *disregard of duty*, than of an error of judgment. It was a non-performance of a confessed official obligation, amounting to what the law considers *a breach of trust* . . . . It

> amounted to an *illegal application of the profits due to the stockholders* of the bank, into which a court of equity will inquire to prevent its being made.

Id. at 345 (emphasis added).

In *Truncale*, the board of directors of Universal Pictures granted stock options to its board and officers. *Truncale*, 76 F. Supp. at 466-67. When the underlying stock reached a high price, the board entered into an agreement with the Commissioner of Internal Revenue to refrain from taking a corporate tax deduction in return for which the Commissioner would not assess income taxes upon the option holders. *Id.* The court held, "Here . . . the corporation has been *deprived of its freedom of action* and has been damaged and for purposes of this motion it is conceded that there is *a good cause of action* . . . for recovery of the corporation's losses." *Truncale*, 76 F. Supp. at 469 (emphasis added).

In *Spirt*, the court was asked whether directors had a fiduciary duty to prevent the "corporation's relinquishment of any claim to tax deductions attributable to [certain] stock options." *Spirt*, 232 F.2d at 242. The court responded, "As directors the defendants did owe the corporation fiduciary duties not to waste or give away its assets." *Id.* at 246. Despite this, the court found that because the "tax deduction was very doubtful," the board could not be held liable for negligence. *Id.* at 247

Very recently, in *Resnik v. Woertz* plaintiffs argued that the § 162(m) plan put in place by Archer-Daniels-Midland failed to meet the requirements of § 162(m) thereby preventing the corporation from claiming a deduction. *Resnik v. Woertz*, 774 F. Supp. 2d at 623-24. The United States Court for the District of Delaware determined that, under Delaware law, allegations of a breach of fiduciary duty withstood a motion to dismiss because "Individual Defendants . . . [did not] adhere[] to the SEC regulations and *§ 162(m) of the IRC*, thereby causing executive compensation to be non-tax-deductible." *Resnik v. Woertz*, 774 F. Supp. 2d at 633 (emphasis added).

Defendants cite a single case – *Haber v. Bell*, 465 A.2d 353 (Del. Ch. 1983) – to argue that the Board does not have a duty to minimize taxes. Defs.' Br. at 25. But *Haber* does not support that argument; it simply states that when a board foregoes a tax deduction they need a valid business purpose for doing so. In *Haber*, there was a valid reason for the board to forego a tax deduction: by doing so, the board also gave a "tax benefit" to its employees, which the court called a "form of compensation." *Haber*, 465 A.2d at 359. Indeed, the Delaware Supreme Court has held that a board must minimize taxes unless it has a valid business purpose for doing otherwise. *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 600-01 (2010) (court acknowledged that protecting a tax benefit – net operating loss carryforwards ("NOLs") – was an "important corporate objective").

Here, unlike *Haber*, Republic received absolutely no benefit when its Board decided to violate its own compensation plans in ways that made them non-tax-deductible under § 162(m). As a result, as shown below, unlike *Versata*, the Board failed to protect the tax benefits of these plans. This violates defendants' duty of loyalty, which includes a duty to minimize taxes.

A. The EIP Cannot Provide Tax-Deductible Compensation under § 162(m) because O'Connor Received an "Incentive" Payment That "Ha[s] Not Been Determined to Have Been Earned" upon His Retirement

The Complaint alleged the award of $1,250,000 to O'Connor on his retirement – the "full target amount" – was non-deductible under § 162(m) and that as a result of this award, the EIP can no longer provide tax-deductible compensation. Compl. ¶¶ 14-24.

Section 162(m)'s implementing regulation – Treas. Reg. § 1.162-27(e)(2)(v) (2011) – states that compensation is not tax-deductible under § 162(m) if the employee "would receive all or part of the compensation regardless of whether the performance goal is attained." However, there are three exceptions to this rule: "Compensation does not fail to be qualified performance-based compensation merely because the plan allows the compensation to be payable upon *death, disability, or change in control*." *Id.* (emphasis added). The regulation hastens to add that the "compensation actually paid *on account of those events* prior to attainment of the performance goal" is not tax-deductible. Treas. Reg. § 1.162-27(e)(2)(v) (emphasis added). Therefore, O'Connor $1,250,000 award failed to comply with this regulation in two ways: (1) retirement is not one of the three exceptions identified in Treas. Reg. 1.162-27(e)(2)(v), and (2) O'Connor's award was "actually paid . . . prior to attainment of the performance goal." Defs.' Ex. B at 20 ¶ 25 (O'Connor's "full target" payment "ha[s] not bee determined to have been earned pursuant to the [EIP]"). There have been several I.R.S. Private Letter Rulings that have attempted to determine whether retirement should be included as an exception to Treas. Reg. § 1.162-27(e)(2)(v) like "death, disability or change in control"; their history demonstrates a nightmare of inconsistency.

I.R.S. Priv. Ltr. Rul. 99-49-014, 1999 PLR LEXIS 1393 (Sept. 9, 1999), addressed a taxpayer's question as to whether compensation paid under a plan upon the attainment of a performance goal would be tax deductible under § 162(m)(4)(C) even though the compensation could have been paid upon the executive's termination by the company without cause or termination by the executive with good reason. The letter stated,

> Termination by [c]ompany without cause and termination by an executive with good reason are both *involuntary terminations* similar to terminations as a result of death, disability or change in control. Therefore, based on the facts submitted, we rule that . . . awards under the [p]lan will be considered performance-based, assuming they meet the requirements of section 162(m)(4)(C) of the Code, even though the compensation could be paid upon termination of the executive by [c]ompany without cause or termination by the executive for good reason.

Id. at *6-*7 (emphasis added). The letter seemingly said that a plan will not fail to comply with Treas. Reg. § 1.162-27(e)(2)(v) simply because it can award compensation after "involuntary terminations." 1999 PLR LEXIS 1393, at *6-*7.

I.R.S. Priv. Ltr. Rul. 06-13-012, 2005 PLR LEXIS 1679 (Dec. 5, 2005), addressed a taxpayer's question that was substantially identical to the question in 1999 PLR LEXIS 1393, except that this plan could pay the unearned compensation upon the executive's retirement. 2005 PLR LEXIS 1679, *2-*3. This second letter stated that a plan that could award such compensation could be tax-deductible, 2005 PLR LEXIS 1679, at *7, but it did not explain why retirement should be viewed as involuntary, like death, disability, or a change in control. Nonetheless, at this point, according to this letter, compensation that could be paid upon "involuntary terminations" and retirement would not invalidate a plan.

However, the next private letter ruling – I.R.S. Priv. Ltr. Rul. 08-04-004, 2007 PLR LEXIS 2296 (Sept. 21, 2007) – completely reversed this trend. This letter addressed a taxpayer's question that was substantially identical to the questions in 1999 PLR LEXIS 1393. It asked if a plan could still provide tax-deductible compensation "even though the compensation could have been paid upon [e]xecutive's termination without 'cause' or for 'good reason,' [i.e., for involuntary reasons] without attaining the performance goal." This third letter said it could not:

> The provision in the [a]greement allowing for payment of performance share or performance unit awards under the [p]lan upon Executive's termination by Company without cause or by Executive with good reason *does not meet the exception* in section 1.162-27(e)(2)(v) of the regulations *that allows compensation to be payable upon death, disability or change of ownership or control*. Thus, compensation paid to Executive with respect to performance share or performance unit awards is not payable solely upon attainment of a performance goal, for purposes of section 162(m)(4)(C) of the Code.

2007 PLR LEXIS 2296 at *4-*5 (emphasis added). So, at this point, the list of acceptable "exceptions" had been limited back to "death, disability or change of ownership or control." *Id.*

Finally, on February 21, 2008, the I.R.S. issued Rev. Rul. 2008-13, 2008-1 C.B. 518, 2008 IRB LEXIS 141, which concluded that compensation can be payable upon termination for cause or with good reason or voluntary retirement is not tax-deductible under § 162(m). *Id.* at *4.

Defendants contend that the $1,250,000 payment is tax-deductible because (1) O'Connor was not a "covered employee" when the Company paid this award in 2011, Defs.' Br. 17 and (2) Rev. Rul. 2008-13 does not apply to this payment. Defs.' Br. at 19-21. Finally, defendants argue that even if O'Connor's award is not tax-deductible, the EIP is tax-deductible for other participants. *Id.* at 20 n.15. Defendants' arguments fail on all three points.

1. <u>Defendant O'Connor Was a "Covered Employee" at the Relevant Time</u>

Section 162(m)'s limit on tax-deductible compensation only applies to the "covered employees" of a given incorporation. § 162(m)(1). One such "covered employee" is the CEO "as of the close of the taxable year." § 162(m)(3)(A). Treas. Reg. § 1.162-27(c)(2)(A) states that for purposes of § 162(m), the corporation's CEO is the person who occupies that position "on the last day of the taxable year." O'Connor retired effective January 1, 2011. Defs.' Ex. C at 1. He was therefore Republic's CEO on December 31, 2010, which was the last day of the Republic's fiscal year. Defs.' Ex. A at Title Page. The last day of the fiscal year is also the last day of Republic's taxable year. I.R.C. § 441(b)(1) (2006) ("'taxable year' means – (1) taxpayer's annual accounting period if it is a calendar year or a fiscal year"). And in 2010, the Compensation Committee contractually obligated Republic to pay O'Connor his full target amount of LTIP compensation – $1,250,000 – for the performance period 2009-2011 contingent upon him retiring as of Jan. 1, 2011. Defs.' Ex. C at 1-2. Therefore, this amount was *awarded* to O'Connor at the latest in 2010.

Defendants argue that the relevant year for purposes of determining a "covered employee" under § 162(m) is the year that compensation is *paid*. Defs.' Br. at 17. And, the $1,250,000 will be paid (or has been paid) in 2011. *Id.* Defendant's analysis is incorrect – the relevant year is not the year such compensation is paid, but the year it is awarded. The regulations interpreting § 162(m) make this clear.

Treas. Reg. § 1.162-27(e)(2)(v) states,

> [I]f the payment of compensation under a grant or *award* is only nominally or partially contingent on attaining a performance goal, none of the compensation *payable* under the grant or award will be considered performance-based.

(Emphasis added.) This language is almost identical to language in the following paragraph regarding stock options:

> if the amount of compensation the employee will receive under the grant or *award* is not based solely on a increase in the value of the stock after the date of grant or award . . . none of the compensation *attributable* to the grant or award is qualified is qualified performance-based compensation . . . .

Treas. Reg. § 1.162-27(e)(2)(vi)(A) (emphasis added).

The Chief Counsel of the I.R.S., interpreting this second provision held,

> Taxpayers have argued that whether an amount is deductible under § 162(m) should be based on the facts existing as of the last day of the taxable year for which the employer would claim the deduction, because it is not known until the last day of the taxable year whether an employee is a covered employee. Thus, the determination whether the compensation is performance-based should not be made before the compensation is paid (when an option is exercised). . . . *This argument fails because the regulations specifically require that the determination whether compensation attributable to stock options is performance-based compensation be made at the time of grant*, not at the time of exercise. Regs. § 1.162-27(e)(2)(vi)(A).

Pl.'s Ex. 24 (I.R.S. Chf. Couns. Mem. 2009-006, 2009 WL 2138881 (July 17, 2009)). This analysis of the language found in Treas. Reg. § 1.162-27(e)(2)(vi) is instructive for the nearly identical language found in Treas. Reg. § 1.162-27(e)(2)(v). Consequently, the relevant year for determining whether an employee is a "covered employee" is the year that the compensation is "granted or awarded" not when it is paid.

Defendants cite a number of Private Letter Rulings for the proposition that "section 162(m)'s deductibility limit did not apply to payments made after an executive retired because he was not a 'Covered Employee' on the last day of the tax year in question." Defs' Br. at 17-18 n.13. However, none of these ruling say that the relevant year for assessing who is a "covered employee" is the year compensation is paid.[1] And, since the I.R.S. chief counsel says the relevant year is the year the award is made and there is no contrary authority, this court should find that the relevant year for assessing O'Connor's award of $1,250,000 was at the latest 2010.

2. <u>Revenue Ruling 2008-13 Applied To O'Connor's "Full Target Amount" Award</u>

On February 21, 2008, the I.R.S. published Rev. Rul. 2008-13, 2008 IRB LEXIS 141, that, as noted above, finally put to rest the idea that compensation can comply with § 162(m) even if it could be awarded after an employee's retirement. Unfortunately, the ruling mistakenly stated that it would not apply "if . . . (i) the performance period for such compensation begins on or before January 1, 2009," nearly a year after the ruling was published. *Id.* at *9-*10. This mistake was unfortunate because the I.R.S. usurped congressional power and misread a tax statute – I.R.C. § 7805(b)(8) (2006) – all in one sentence.

While Rev. Rul. 2008-13 provided a valid interpretation of Treas. Reg. 1.162-27(e)(2)(v), the I.R.S. failed to only limit its application retroactively and instead limited its application prospectively. This limitation exceeded the statutory power granted to the I.R.S.

[1] One these rulings says that "compensation paid with respect to" any year that an officer is not a "covered employee" is fully deductible. I.R.S. Priv. Ltr. Rul. 99-10-011, 1998 PLR LEXIS 2233 (Dec. 4, 1998). However, compensation is paid "with respect to" the year it was awarded, not the year when this compensation actually changed hands. Therefore, because O'Connor was a "covered employee" in 2010, and this was the year "with respect to" his award of $1,250,000, this compensation must comply with § 162(m) to be deductible.

I.R.C. § 7805(b)(8) (2006) ("The Secretary may prescribe the extent, if any, to which any ruling . . . relating to the internal revenue laws *shall be applied without retroactive effect*) (emphasis added). It also contradicted the history of Revenue Rulings, which apply retroactively and prospectively when silent on the issue. *Manocchio v. Comm.*, 78 T.C. 989, 1000 (T.C. 1982) (where a revenue ruling is silent on the issue, "it is automatically deemed by the Commissioner to have [both prospective and] retroactive application").

More important, however, is the fact that by deciding to limit the prospective application of this Revenue Ruling, the I.R.S. exceeded the bounds of its powers to interpret and trespassed on territory limited to Congress – the ability to make law. The Secretary cannot decide to enforce a tax law only at some given point in the future because the ability to determine when a law will apply and when it will not is "tantamount . . . to vesting" an institution with "the power not only to interpret but also to create the law." *Medellin v. Texas*, 552 U.S. 491, 516 (U.S. 2008) (U.S. Supreme Court held the judiciary did not have this power with regard to treaties).

The Supreme Court of the United States has made it clear that

> *Congress, not the Commissioner, prescribes the tax laws*. The Commissioner's rulings have only such force as Congress chooses to give them, and Congress has not given them the force of law.

Dixon v. United States, 381 U.S. 68, 72-73 (U.S. 1965) (emphasis added). Consequently,

> the Commissioner is empowered *retroactively to correct mistakes of law* in the application of the tax laws to particular transactions. He may do so even where a taxpayer may have relied to his detriment on the Commissioner's mistake.

Id. (emphasis added). But the I.R.S. cannot determine that one interpretation will reign until a date in the future. This ability would allow the I.R.S. to actually create the laws, rather than to simply interpret what Congress meant.

Amazingly, in making this error, the I.R.S. cited to the very statute being misread:

> *Pursuant to IRC § 7805(b)(8)*, the holdings in this revenue ruling will not be applied to disallow a deduction for any compensation that otherwise [qualified as performance-based under § 162(m)] if . . . (i) the performance period for such compensation begins on or before January 1, 2009.

Rev. Rul. 2008-13, 2008 IRB LEXIS 141, at *9-*10. This determination contravened that I.R.C. section, and so it is void. *Cartanza v. Del. Dept. of Natural Res. & Envtl. Control*, 2008 Del. Ch. LEXIS 205, at *30 n.47 (Del. Ch. Oct. 10, 2008) ("'The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is . . . (only) the power to adopt regulations to carry into effect the will of Congress as expressed by statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity'") (quoting *U.S. v. Larionoff*, 431 U.S. 864, 873 n.12 (U.S. 1977)).

In addition, although there does not appear to be any case law on the severability of a revenue ruling, the U.S. Supreme Court has stated that an administrative regulation is severable and its non-offensive provisions should remain intact so long as "[t]he severance and invalidation of [the] subsection will not impair the function of the statute [it interprets] as a whole, and there is no indication that the regulation would not have been passed but for its inclusion." *K Mart Corp. v. Cartier, Inc., et al.*, 486 U.S. 281, 294 (U.S. 1988). Here, the invalidation of this timing provision will do nothing to harm the § 162(m), Treas. Reg. 1.162-27(e)(iv) or the remainder of Rev. Rul. 2008-13. Consequently, the court should invalidate only the timing provision while retaining the rest of the Revenue Ruling. As such, this provision of Rev. Rul. 2008-13, 2008 IRB LEXIS 141, at *9-*10, is void and the Secretary's interpretation of Treas. Reg. 1.162-27(e)(iv) should be read to affect all § 162(m) compensation, or at the very least that compensation which was awarded after February 21, 2008, the date of the publication. Therefore, O'Connor's payment of $1,250,000 cannot be tax-deductible.

Defendants do not argue that delaying the application of Rev. Rul. 2008-13 to performance periods beginning as late as January 1, 2009, was a permissible exercise of administrative authority; they do not even cite I.R.C. § 7805(b)(8). Instead, defendants argue that even if plaintiff's reasoning is sound, "his point is entirely academic . . . [because g]iven the IRS' position, Republic had every right to claim deductions for payments made to O'Connor." Defs.' Br. at 20. This is not the case.

In the first place, the I.R.S.'s citation to I.R.C § 7805(b)(8) in the same sentence that it postponed its enforcement for plans beginning on or before January 1, 2009 alerted the whole world that this postponement was void. Defendants merely needed to read the statute. In addition, in paying O'Connor his "full target amount" defendants were taking an extremely risky chance because when the I.R.S. corrects its mistake, not only will O'Connor's payment be held non-tax-deductible, but, as demonstrated below, the tax-deductibility of the entire EIP was at risk. The fact that defendants have not pointed to a single other revenue ruling that has similarly postponed its application is indicative of the irregularity and illegality of this provision – its correction was inevitable. That defendants chose to gamble here is indicative of their overall policy of giving excess compensation at all costs.

In addition, as mentioned above, even if Rev. Rul. 2008-13 does not apply to O'Connor's award, it is still not tax deductible under § 162(m) because it was "actually paid . . . prior to attainment of the performance goal" which is not permissible under Treas. Reg. § 1.162-27(e)(2)(v). *See* Defs.' Ex. B at 20 ¶ 25 (O'Connor's "full target" payment "ha[s] not been determined to have been earned pursuant to the [EIP]").

3. O'Connor "Full Target" Award Makes the Entire EIP Non-Tax-Deductible under § 162(m)

Finally, defendants claim that even if O'Connor's "full target award" is non-deductible under § 162(m), this does not mean that the entire EIP is non-deductible as the Complaint alleged in paragraph 23. Defs.' Br. at 18. Defendants have it backwards: even if this Court decided O'Connor's payment is deductible despite the arguments above, this payment has fundamentally changed the EIP without shareholder approval so the EIP can no longer provide deductible compensation under § 162(m). Indeed, this relatively small payment had a far-reaching and devastating effect on EIP tax-deductibility.

The 2009 proxy statement instructed shareholders that "[a]ssuming [the EIP] is approved, future payments under that plan, including annual, long-term and synergy payments, are intended to qualify as performance-based compensation that complies with Section 162(m)." Defs.' Ex. F at 29. That year shareholders did approve the EIP. *Seinfeld v. O'Connor*, 774 F. Supp. 2d 660, 663 (D. Del. 2011). Such approval allowed Republic to deduct compensation under § 162(m) so long as the terms of the EIP remained the same. However, when O'Connor was paid $1,250,000 upon his retirement – the "full target amount" of his "long term incentive award" under the EIP for 2009-2011– despite the fact that this award "ha[d] not been determined to have been earned pursuant to the Plan" it permanently modified the terms of the EIP. Defs.' Ex. B at 20 ¶ 25; Defs.' Ex. C at 2.

The Complaint alleged the defendants did not follow the EIP because "requiring the payment to defendant O'Connor of a bonus that is unearned because of his retirement. . . " violates § 162(m). Compl. ¶ 23. This payment violates § 162(m) because it materially modified the EIP. Consequently, it "renders the entire EIP non-tax-deductible" under § 162(m). Compl. ¶ 23.

In order for compensation to be deductible under § 162(m), "the material terms under which the remuneration is to be paid, including the performance goals, [must be] disclosed to shareholders and approved by a majority of the vote. . . ." § 162(m)(4)(C)(ii). Section 162(m)'s implementing regulation – Treas. Reg. 1.162-27 – states that a new shareholder vote must be conducted whenever "the compensation committee changes the material terms of the performance goals." Treas. Reg. 1.162-27(e)(4)(vi). Here, although an original shareholder vote approved the EIP, the plan as changed has not been submitted to shareholders for approval. Therefore, the EIP cannot yield tax-deductible compensation under § 162(m).

The EIP was materially changed when O'Connor was awarded his "full target amount" because this award changed the EIP so that § 5.3 of the EIP can now modify § 4.2 of the EIP. Section 5.3 did not have this power when shareholders approved it. As drafted and presented to shareholders § 5.3 only included discretion to limit the application of §§ 5.1 and 5.2 of the EIP:

> Committee Discretion. The provisions of *Sections 5.1 and/or 5.2 hereof [defining "Termination of Employment"] shall not apply* to any Participant or Participants if and to the extent (i) determined by the Committee prior to the expiration of the Determination Period, in its sole and absolute discretion, or (ii) provided in any employment, consulting or other agreement for the performance of services between the Participant and the Company.

Defs.' Ex. I at A-6 § 5.3. However, § 5.3 said nothing about § 4.2 which required that all "Awards" under the EIP must be made

> *only to the extent that the Performance Goals(s) for such Award are achieved* and the Award Formula as applied against such Performance Goal(s) determines that all or some portion of such Participant's Award has been earned for the Performance Period. As soon as practicable after the close of each Performance Period, the Committee shall meet to review and *certify* in writing whether, and *to what extent*, the Performance Goals for the Performance Period have been achieved and, if so, to calculate and certify in writing that amount of the Award earned by each Participant for such Performance Period based upon such Participant's Award Formula. The Committee *shall then determined the actual amount of the Award* to be paid to each Participant and *in so doing may use*

> *negative discretion to decrease, but not increase, the amount of the Award otherwise payable to the Participant based upon such performanc*e.

Defs.' Ex. I at A-4 § 4.2 (emphasis added).

The Compensation Committee, however, has extraordinary discretion to "to prescribe, amend and rescind ruling relating to the . . ." EIP. *Id.* at A-6 § 6.1. Therefore, this "amend[ment]" is specifically contemplated by the EIP. Now, and apparently going forward, defendants will interpret § 5.3 as giving them power to overrule § 4.2, if not all other provisions of the EIP. However, simply because the defendants can modify the EIP does not mean that the EIP can provide tax-deductible compensation under § 162(m). Such compensation will not be tax-deductible until defendants submit these material changes for shareholder approval. Treas. Reg. 1.162-27(e)(4)(vi). Therefore, any payments made under the EIP, including any Synergy Plan payments (which were approved by the shareholders when they approved the EIP) are not tax-deductible going forward.

Defendants respond that O'Connor's non-tax-deductible award cannot render the entire EIP non-tax-deductible because the determination of tax-deductibility is made on a "grant-by-grant basis." Defs.' Br. at 20 n.15. However, the fact that this award was made is indicative of an overall change to the EIP that has not been approved by shareholders, which means that this payment does indeed make the entire EIP non-deductible under § 162(m). In addition, the grant-by-grant rule has "an exception" known as the "facts-and-circumstances" rule, by which "all plans, arrangements, and agreements" are taken into account to determine tax-deductibility. Treas. Reg. § 1.162-27(e)(2)(v). Thus, the EIP must be capable of providing § 162(m) compensation in order for any individual award to be tax-deductible under § 162(m). Because shareholders have not approved the changed plan, it cannot provide such tax-deductible compensation.

Moreover, the O'Connor agreement concerning his possible retirement and payments to him under the three-year plan January 1, 2009 through December 31, 2011, were "hidden." Compl. ¶ 24. Indeed, the only place this was ever explained this to shareholders was on a single page in Repulic's 2009 proxy statement in a section that had nothing to do with the approval of the EIP. Def. Ex. F. at 39. It was not disclosed in the proposal to approve the EIP in a paragraph entitled Termination of Employment, which is where it should have been. This was a buried fact. *Weingarden v. Meenan Oil Co.*, 1985 Del. Ch. LEXIS 374, at *9 (Del. Ch. Jan. 2, 1985) ("disclosure is inadequate" if it is "buried in the proxy materials," not under an "appropriate heading [or] cross referenced"). But even if a reasonable stockholder had read page 36 "disclosure" at the same moment that he read the Termination of Employment section of the proposal to approve the EIP, he would not know whether the page 36 material trumped the Termination language or the other way around. The page 36 disclosure was inadequate.

The U.S. District Court was misinformed about the O'Connor contract. That court said,

> *[A]s Republic points out*, the compensation plan involved in the Revenue Ruling [2008-13] provided 'compensation will be paid without regard to whether the performance goal is attained,' in the event a covered employee retired. That is not the situation here…. *Seinfeld might have a point if the EIP provided for payments based solely on retirement, but, as already explained [payments are based on the attainment of performance goals], it does not*.

Seinfeld v. O'Connor, 774 F. Supp. 2d 660, 669-70 (D. Del. 2011) (citations omitted). Based on this misrepresentation by Republic, the court rejected plaintiff's efforts to raise the fact of the "bonus payments made to a retiring executive ***after*** the filing of his complaint," i.e., the $1,250,000 payment, as coming too late. *Id.* at 670 n.7 (double emphasis in original). The court then dismissed the direct claims under 15 U.S.C. § 78n(a) (2006) for failure to state a claim, but it dismissed the derivative claims as lacking federal jurisdiction. *Seinfeld v. O'Connor*, 774 F. Supp. 2d at 673 n.12. In that footnote the court noted:

> The Court notes that Seinfeld also arguably raises theories of waste and unjust enrichment in his derivative action. Whatever the merits of those claims, however, the derivative claims are all based on Delaware state law causes of action, namely breach of fiduciary duty.

Id. (citations omitted) Following the District Court's guidance, Seinfeld commenced the action at bar.

Defendants seek to justify their limited revealment of the facts to the federal court by saying that they "did nothing wrong" and had no obligation to do anything more. Defs.' Br. at 22 n.17. The federal court did not have such a limited view. It said,

> *As Republic explains*, the EIP makes clear that a performance based award for an executive who has retired is *limited* to a pro-rata proportion of any award . . . that such award will not be payable until the performance period ends…. *Under the EIP, no executives will receive any compensation merely because they retire*.

Seinfeld v. O'Connor, 774 F. Supp. 2d at 669 (emphasis added).

Defendants claim plaintiff "has only himself to blame" for not locating the "full target amount" payable to O'Connor upon his retirement so that he could properly point out defendants' misrepresentations to the federal court. Defs.' Br. at 22 n.17. But the federal court also reviewed Republic's 2009 proxy statement, and was unable to locate this hidden fact:

> THE COURT: Do you agree I can look at the full text of the proxy statement on a motion to dismiss?
>
> MR. GERSHON: Yes, your Honor.
>
> THE COURT: And the proxy statement I believe attaches to it the EIP plan itself and the Synergy Plan?
>
> MR. GERSHON: Yes.
>
> THE COURT: I can look at those as well?
>
> MR. GERSHON: Absolutely, your Honor.
>
> THE COURT: Okay. You can go on.

Pl.'s Ex. 25 (Official Transcript, 22:5-13). The federal court's opinion did not mention the buried fact that the EIP could pay O'Connor the "full target amount" upon his retirement. It said the opposite, so by the defendants' logic, the federal court is as blameworthy as the plaintiff.

In sum, because O'Connor's payment was non-tax-deductible under § 162(m), because the payment (even if it was deductible) materially changed the plan without shareholder approval making the entire EIP non-deductible under § 162(m) and because this payment was hidden from shareholders until Republic had contractually obligated itself to pay O'Connor, the payment is a violation of defendants' fiduciary duty to minimize taxes.

The Delaware Supreme Court has defined waste as "'an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.'" *Brehm*, 746 A.2d at 263 (quoting *Vogelstein*, 699 A.2d at 336). The Complaint alleged that O'Connor should not have been paid his "full target amount," but should only have received two-thirds of this award – thereby preserving the deductibility of the EIP. Compl. ¶ 14. Therefore, the difference between maintaining a tax-deductible EIP under § 162(m) and not doing so was $416,666 – one-third of O'Connor's $1,250,000 award. This single payment destroyed the § 162(m) deductibility of the EIP. Republic has granted million of dollars of compensation under the EIP since O'Connor's payment made all such payments non-tax-deductible under § 162(m). Therefore, in exchange for whatever consideration Republic derived from paying an extra $416,666 to a retired employee, Republic lost millions in present and future tax deductions on top of paying this extra $416,666. No "reasonable person" would make this exchange, especially when this amount is compared to the nearly $39 million O'Connor would otherwise receive after his retirement. Consequently, plaintiff has properly alleged a claim of waste.

B. Synergy Plan Payments Are Non-deductible under § 162(m)

Because the EIP can no longer award tax-deductible compensation under § 162(m) since O'Connor's "full target amount" payment was awarded, no Synergy payments are deductible since the Synergy Plan is part and parcel of the EIP. *See* Defs.' Ex. G at B-4 § VIII (B) ("the Synergy Incentive Plan shall not be effective unless [the EIP] is approved by the shareholders of the Company "). However, even if the EIP could provide tax-deductible compensation under § 162(m), the Synergy Plan cannot since its awards are not contingent on "incremental and ongoing impact to EBIT attributable to the combination of Republic and Allied . . . measured over the baseline which including the operation of the two businesses standalone" as the terms of the plan required. *Id.* at B-6. As § 162(m)(4)(C) makes clear, only compensation "payable solely on account of the attainment of one or more [shareholder pre-approved] performance goals" is deductible under that statute. By paying out Synergy Awards that did not conform to the shareholder-approved goal – increased EBIT over baseline – Republic has awarded compensation that is not deductible under § 162(m). These awards constitute a violation of defendants' duty to minimize taxes and, as with the above EIP compensation, they are wasteful.

C. Republic's Stock Plan Restricted Stock Awards Are Non-deductible under § 162(m)

As defendants admit, [a]ccording to the Company's disclosures, the grants to Covered Employees [of restrict stock awards] have all been time-based and therefore none are deductible." Defs.' Br. at 8. Because the shareholder-approved Stock Plan invites the award of tax-deductible restricted stock, the fact that absolutely none of the restricted stock that has been granted is tax-deductible under § 162(m) constitutes a violation of defendants' duty to minimize taxes and, as with the above EIP compensation, they are wasteful.

IV. PLAINTIFF HAS PROPERLY STATED CAUSES OF ACTIONS FOR WASTE AND UNJUST ENRICHMENT DUE TO REPUBLIC'S EXCESSIVE NON-PERFORMANCE EQUITY COMPENSATION AND DIRECTOR COMPENSATION

This court has found several times that when a corporate transaction is sufficiently "unusual" this will allow a waste claim to survive a motion to dismiss. *Telxon Corp. v. Bogomolny*, 792 A.2d 964, 976 (Del. Ch. 2001) (followed by *In the Matter of TEU Holdings Inc.*, 287 B.R. 26, 34-35 (Bankr. D. Del. 2002); *Vogelstein*, 699 A.2d at 339; *In re Nat'l Auto Credit, Inc. S'holders Litig.*, 2003 Del. Ch. LEXIS 5, at *54-*55 (Del. Ch. Jan. 10, 2003).

A. Republic's Awards of Excessive Director Compensation Requires Factual Analysis for Waste Because These Awards Are Unusual

The Complaint alleges that the one-time stock options grants made to Republic's non-employee Board members were so "unusual" as to require factual development through discovery for plaintiff's allegation of corporate waste. Compl. ¶¶ 35-36. This Court has stated,

> [D]irectoral self-compensation decisions lie outside the business judgment rule's presumption protection, so that, where properly challenged, the receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation.

Nat'l Auto Credit, 2003 Del. Ch. LEXIS 5, at *54-*55. Consequently, challenged director compensation must survive an entire fairness examination. Since the entire Board was interested when it approved these plans, the burden shifts to defendants to prove that these plans were entirely fair, a burden that is nearly impossible to satisfy on a motion to dismiss:

> As our Supreme Court has recognized, a determination that entire fairness is the appropriate standard of review "is often of critical importance." *That conclusion normally will preclude dismissal of a complaint on a . . . motion to dismiss*. Once the business judgment rule presumption is rebutted, the burden of proof shifts to the defendant, who must either establish the *entire fairness* of the transaction or show that the burden of disproving its entire fairness must be shifted to the plaintiff. *A determination of whether the defendant has met that burden will normally be impossible by examining only the documents the Court is free to*

> *consider on a motion to dismiss–the complaint and any documents it incorporates by reference.*

Orman v. Cullman, 794 A.2d 5, 20 n.36 (Del. Ch. 2002) (emphasis added).

Here, the Complaint alleges that the director compensation at issue was "unusual" for two reasons: (1) because, as shown above, non-employee directors' compensation is tremendously high compared to its peer group, and (2) directors gave themselves a one-time payment to directors of $557,775 in restricted stock units. Compl. ¶¶ 35-36.

This court has previously determined that excessive and unusual director compensation survives a motion to dismiss. In *Vogelstein*, the court held that an excessive one-time stock option grant to an interested board that was valued "as much as $180,000 per director" was sufficiently "unusual" to survive a motion to dismiss. *Vogelstein*, 699 A.2d at 331. While the court dismissed plaintiff's disclosure claim, the court upheld the waste claim simply because

> I cannot conclude that no set of facts could be shown that would permit the court to conclude that the grant of these options, particularly focusing upon the one-time options, constituted an exchange to which no reasonable person not acting under compulsion and in good faith could agree. In so concluding, I do not mean to suggest a view that these grants are suspect, only that *one time option grants to directors of this size seem at this point sufficiently unusual to require the court to refer to evidence before making an adjudication of their validity and consistency with fiduciary duty*. Thus, for that reason the motion to dismiss will be denied.

Id. at 639 (emphasis added).

Consequently, the one-time payment to directors of $557,775 in restricted stock units, which is more than three-times the one-time payment determined to be "unusual" in *Vogelstein*, is itself unusual. In addition, the extremely high compensation non-employee directors received compared to their peer group demonstrates the excessive nature of this compensation.

Defendants combat this argument with a single case: *In re 3COM Corp. S'holders. Litig.*, 1999 Del. Ch. LEXIS 215 (Del. Ch. Oct. 25, 1999). Defs' Br. at 31-32. However, in *3COM* plaintiff's "only factual allegation about the options is that the dollar values on these options were quite large . . . ." *3COM*, 1999 Del. Ch. LEXIS 215, at *14. Here, by comparison, plaintiff has alleged facts demonstrating that Republic's peers paid far less in director compensation, and, like in *Vogelstein*, this case involves the payment of a one-time award of $557,775 to defendant directors. As the *3COM* court said when confronting *Lewis v. Vogelstein*, "an allegation of waste 'is inherently factual.'" *3COM*, 1999 Del. Ch. LEXIS 215, at *16. Here, the facts mirror those of *Vogelstein*, rather than those of *3COM*. Therefore, this court should uphold plaintiff's claims of waste and unjust enrichment of the director defendants.

B. Republic's Awards of Excessive Non-Performance-Based Equity Compensation under the Stock Plan Requires Factual Analysis for Waste Because These Awards Are Unusual

The Complaint also alleged that the amount of non-tax-deductible compensation paid out to defendants under the Stock Plan was "unusual" because, as demonstrated above, their peers tie nearly all of their equity compensation to performance goals and because the purpose of the plan was to incentivize performance and join participants' interests to those of shareholders, but the awards granted failed to do this. Compl. ¶¶ 29-33.

In *Telxon Corp*. 792 A.2d at 969, 976, this Court determined that the Telxon board's delivery of an option grant ("the Aeronet Option") to its CEO in return for a "no recourse note" was "unusual." The Aeronet Option was awarded to the CEO so that he could buy 10% of shares of Aeronet – a Telxon subsidiary. *Id.* at 969. The court explained that the CEO "took no risk when he exercised the option because, if Aeronet failed, [the CEO] would merely redeliver the shares to Telxon and have no further liability on the note." *Id.* When this option was presented to shareholders it was "cast . . . as part of the 'Telxon 2000' program." *Id.* at 970. Shareholders were told this program was supposed to provide "'incentive opportunit[ies]'" in order to "'more closely align[employees'] objectives with the long-term goals of the Company as a whole.'" *Id.* at 969. Based on this transaction that did nothing to benefit Telxon and gave the CEO "no risk," this Court found that "the terms and circumstances of the Aeronet Option appear at this point sufficiently *unusual* to require the court to allow the claim to survive beyond the pleading stage." *Id.* at 976 (emphasis added).

Here, similar to the "unusual" compensation discussed in *Telxon*, the Stock Plan was presented to shareholders as a program meant to

> attract, retain, reward and motivate [e]ligible [i]ndividuals by providing them with an opportunity to acquire or increase a proprietary interest in Republic and to *incentivize them to expend maximum effort* for the growth and success of the Company, so as to strengthen the mutuality of the interests between the [e]ligible [i]ndividuals and the shareholders of Republic.

Defs.' Ex. D at A-1. Instead of providing compensation that furthered this goal, only time-based equity compensation was awarded – riskless awards that encouraged participants to do no more than show up. As noted in *Telxon,* "no risk" awards do not incentivize performance and do not "align[employees'] objectives with the long-term goals of the Company as a whole." *Telxon Corp.*, 792 A.2d at 969, 976. Therefore, plaintiff's challenge to this compensation should survive a motion to dismiss.

V. THE COMPLAINT PROPERLY ALLEGES DEMAND FUTILITY

All of plaintiffs' allegations survive defendants R. 23.1(a) challenge because demand is futile for each of these claims. Defendants agree that demand is futile with regard to plaintiffs' allegations regarding the non-employee directors' excess compensation. Defs.' Br. at 31-32. With regard to plaintiff's remaining claims, demand is futile because none of these actions are protected by the business judgment rule. *Aronson v. Lewis*, 473 A.2d at 808 (the law excuses pre-suit demand as futile in a stockholder's derivative action where the directors' conduct was not "entitled to the protections of the business judgment rule"). In addition, with regard to the allegations regarding the Stock Plan, demand is excused because the entire Board is interested in this plan. *Id.* at 812.

A. Demand Is Futile for Plaintiff's Allegations of Waste

This Court has stated that "[i]f a cognizable claim of waste is alleged, that would deprive the challenged conduct of the protection of the business judgment rule and, consequently, would excuse demand." *Leung v. Schuler*, 2000 Del. Ch. LEXIS 41, at *34 (Del. Ch. Feb. 29, 2000); *see also Kaufman v. Beal*, 1983 Del. Ch. LEXIS 391, at *16 (Del. Ch. Feb. 25, 1983). The Delaware Supreme Court has defined waste in two ways: 1) "'an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade,'" and 2) "'a transfer of corporate assets . . . for which no consideration at all is received . . . in effect a gift.'" *Brehm*, 746 A.2d at 263 (quoting *Vogelstein*, 699 A.2d at 336).

As discussed above, the payments of $1,800,000 to O'Connor and $68.1 million under the Synergy Plan are wasteful because there is no consideration for these payments. *See Brehm*, 746 A.2d at 263 (quoting *Vogelstein*, 699 A.2d at 336). In addition, the O'Connor's $1,250,000 "full target amount" payment by itself destroyed the tax-deductibility of both the EIP and the Synergy Plan it contained. This means that until defendants are able to acquire shareholder re-approval of the EIP (as changed), all compensation granted under this plan will not be tax-deductible. If defendants had simply paid O'Connor a pro-rata amount of his compensation under the EIP as was permitted under § 5.2 of the plan, instead of negating the provision by paying O'Connor an extra $416,666, the EIP would still be able to provide compensation that is deductible under § 162(m). Defendants have awarded millions of dollars in compensation under the EIP since this decision was made, none of which is tax-deductible. Because no reasonable person would exchange millions in tax deductions and $416,666 for whatever consideration can be derived from paying this extra $416,666 to a retiring employee, this transaction was a "wasteful exchange of corporate assets for consideration . . . disproportionately small." *Brehm*, 746 A.2d at 263 (quoting *Vogelstein*, 699 A.2d at 336). In addition, the Synergy Plan by itself cannot provide tax-deductible compensation because its terms were not adhered to when defendants granted $68.1 million in awards without any "synergy." Finally, the Stock Plan's excessive non-tax-deductible awards require factual development through discovery for plaintiff's allegation of corporate waste because, as demonstrated above, they are "unusual."

B. Demand Is Futile for Plaintiff's Allegations Based on Violations of the Express Provisions of the Synergy Plan and Stock Plan

Here, "plaintiff[] ha[s] sufficiently alleged facts which, taken as true, show that the . . . Board violated an express [EICP] provision." *Sanders*, 1999 Del. Ch. LEXIS 203, at *14. Violating the express provisions of a stockholder-approved compensation plan is not protected by the business judgment rule. *Sanders*, 1999 Del. Ch. LEXIS 203, at *14; *see also Ryan*, 918 A.2d at 354 (Del. Ch. 2007); *see also Weiss v. Swanson*, 948 A.2d 433, 441 (Del. Ch. 2008) ("the [business judgment] rule applies to the directors' grant of options pursuant to a stockholder-approved plan only when the terms of the plan at issue are adhered to").

As demonstrated in detail above, the Synergy Plan required that any awards would be based on "EBIT impact . . . measured over the baseline which includes the operations of the two businesses standalone." Defs.' Ex. G at B-6. But defendants are prepared to award $68.1 million in compensation despite no EBIT improvement. Pl.'s Ex. 26 at 10. Finally, the excessive awards of non-tax-deductible equity compensation under the Stock Plan violated the Stock Plan's provision requiring that it "incentivize [participants] to expend maximum effort for the growth and success of the Company, so as to strengthen the mutuality of the interests between the [e]ligible [i]ndividuals and the shareholders of Republic." Defs.' Ex. D at A-1. Therefore, demand is futile.

C. Demand Is Futile for Plaintiff's Allegations Based on Violations of the Stock Plan because the Entire Board Is Interested

Demand is also futile for the Complaint's allegations regarding violations of the Stock Plan because the entire Board "participate in and are unjustly enriched by the Stock Plan . . . ." Compl. ¶ 43; Defs.' Ex. D at A-4 ¶ 3(r). *President and Fellows of Harvard College v. Glancy*, 2003 Del. Ch. LEXIS 25, at *68 (Del. Ch. Mar. 21, 2003) (directors are interested in a plan if they are "participants" even if no compensation was ever awarded); *MCG Capital Corp. v. Maginn*, 2010 Del. Ch. LEXIS 87, *65-*66 (Del. Ch. 2010) ("[u]nder the first prong of *Aronson*, demand may be excused as to a director who has a direct financial interest in the challenged transaction").

Recently, the U.S. Court for the District of Delaware, interpreting Delaware law, affirmed this view of director "interest" in two cases where the directors were merely participants in the compensation plan at issue and their compensation was not the focus of the cause of action. *Hoch v. Alexander*, 2011 U.S. Dist. LEXIS 71716, at *15 (D. Del. July 1, 2011) (plaintiff "has properly pled that demand is excused because . . . [a]ccording to the Complaint, all of the members of the board of directors are eligible to participate in the [compensation plan in dispute] and thus have an interest in receiving such payments"), *reargument denied*, No. 11-00217, slip op. 647 (D. Del. Aug. 29, 2011); *Resnik v. Woertz*, 774 F. Supp. 2d at 635. Defendants have offered nothing to rebut this argument.

VI. PLAINTIFF HAS STATED CAUSES OF ACTION WITH REGARD TO DEFENDANTS HOLMES AND DEFENDANT SLAGER

Defendants' claim that defendant Holmes is not a "covered employee" and that therefore "plaintiff has . . . failed to state a claim against Mr. Holmes . . . ." Defs.' Br. at 33-34. In the first place, whether or not Holmes is a "covered employee" does not matter for plaintiff's claims that defendants' have awarded Holmes and others excessive non-performance based compensation that is wasteful. *See* Compl. ¶ 33.

Second, defendants are wrong; Holmes is a "covered employee" under § 162(m). Compl. ¶ 2. Section 162(m)(3)(A) defines "covered employees" as the Company's chief executive officer and the other "four highest compensated officers." § 162(m)(3)(B); *see also* Treas. Reg. § 1.162-27(c)(2)(i)(B). Therefore, the statute states that every public company has *five* "covered employees." And Holmes is Republic's third-highest paid employee. Pl.'s Ex. 13 at 37.

Defendants claim that § 162(m)(3)(B) has been overruled – that as of June 18, 2007 there are only *four* "covered employees" in every public company. Defs.' Br. at 33-34. Defendants do not claim that § 162(m) or its implementing regulation – both of which named *five* "covered employees" – have changed in any way. Rather, they claim that I.R.S. Notice 2007-49, 2007-1 C.B. 1429, 2007 IRB LEXIS 500 ("Notice 2007-49"), has single-handedly overruled the law of the United States so that now § 162(m)(3)(B) should read "*three* highest compensated officers."

Defendants argue this because Notice 2007-49 claims that chief financial officers no longer count as "covered employees." First, because Notice 2007-49 contradicts both § 162(m)(3)(B) and Treas. Reg. § 1.162-27(c)(2)(i)(B), it must fail. *Stobie Creek Investments, LLC v. U.S.*, 82 Fed. Cl. 636, 671 (Fed. Cl. 2008) (a notice does not have the force of law; it is like a "press release stating the IRS's position . . . and informing the public of its intentions");

Guilzon v. Comm., 985 F.2d 819, 822 (5th Cir. 1993) (notices do not even have "the same weight as Revenue Rulings"); *see also PBS Holdings, Inc. v. Comm.*, 129 T.C. 131, 143-45 (T.C. 2007).

Second, this "notice" contradicts common sense. The rationale behind Notice 2007-49 is that a determination of "covered employees" is made with reference to the Exchange Act, and, before 2006, the Exchange Act (like § 162) referred to the CEO and four highest-compensated officers in its disclosure rules. But, in 2006 the SEC changed their rules to make sure that every single CFO would have his compensation reported to shareholders. Executive Compensation and Related Person Disclosure, Securities Act Release Nos. 33-8732A; 34-54302A; IC-27444A, 71 Fed. Reg. at 53,166, 53,189 ("[t]he amendments to the compensation disclosure rules are intended to provide investors with a clearer and more complete picture of compensation to . . . principal financial officers" because the CFO "has important responsibility for the fair presentation of the company's financial statements and other financial information"). Consequently, these rules were intended to put CFO compensation under *more*, not less shareholder scrutiny. To accomplish this goal, the SEC disclosure rules now specify that companies must disclose the compensation of (1) the CEO, (2) the CFO and (3) the other three most highly compensated individuals. Regulation S-K, 17 C.F.R. 229.402(a)(3).

Instead of looking at § 162(m) and the new Regulation S-K logically by stating that the CFO is a "covered employee" so long as he is one of the "four highest compensated officers," the I.R.S. issued Notice 2007-49, which contradicts both the law, spirit and purpose of § 162(m). Notice 2007-49, in eliminating the CFO from the definition of covered employees, is unreasonable and inconsistent with the statutory scheme so it must fail. *Eliason v. Englehart*, 733 A.2d 944, 946 (1999) ("[t]he goal of statutory construction is to determine and give effect to legislative intent"); *Reddy v. PMA Insurance Co.*, 20 A.3d 1281, 1288 n.33 (2011) (the literal words of a statute cannot be applied to yield an unreasonable result not contemplated by the legislature). Therefore, the Court should include Holmes within the definition of "covered employees" because Notice 2007-49 is inconsistent with the statutory scheme and purpose of § 162(m), the Service's own rules and regulations, and common sense.

In addition, defendants' argue that plaintiff has failed to state a cause of action against defendants Holmes and Slager because they only *received* wasteful compensation. Defs' Br. at 33-34. However, plaintiff has stated a cause of action against defendants Holmes and Slager because the Complaint alleges they have been unjustly enriched under the Stock Plan and the EIP, and Synergy Plan. Compl. ¶¶ 33, 38, 46, 48. To allege an unjust enrichment, plaintiff must provide facts that conceivably demonstrate "(1) an enrichment, (2) an impoverishment, (3) a relation between the enrichment and impoverishment, (4) the absence of justification and (5) the absence of a remedy provided by law." *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 393 (Del. Ch. 1999). Here, with regard to Slager and Holmes plaintiff has demonstrated that in their Stock Plan, EIP and Synergy Plan payments, that they have been enriched, Republic has been impoverished and that there is no justification for this waste.

CONCLUSION

For the foregoing reasons, plaintiff respectfully requests that the court deny defendants' motion to dismiss.

Dated: December 23, 2011

BIGGS and BATTAGLIA

By: /s/ Robert D. Goldberg
Robert D. Goldberg (I.D. No. 631)
921 North Orange Street
Wilmington, DE 19899
Tel: 302-655-9677
goldberg@batlaw.com
Attorneys for Plaintiff

Of Counsel:

BARRACK, RODOS & BACINE
Alexander Arnold Gershon
Michael A. Toomey
425 Park Ave., 31st Floor
New York, NY 10022
(212) 688-0782

BARRACK, RODOS & BACINE
Daniel E. Bacine
Two Commerce Square
2001 Market Street – Suite 3300
Philadelphia, PA 19103
(215) 963-0600