Open Season on Proxy Statements? Entrepreneurial Plaintiffs' Lawyers Target Executive Compensation Disclosure

As we enter the 2013 proxy season, companies should be aware of a new flavor of shareholder litigation. Some of the same firms that routinely attack M&A transactions have set their sights on a new target: attacking "say-on-pay" and other compensation-related disclosures in annual proxy statements. Using the leverage of the threats of enjoining the shareholder vote and the burden of substantial discovery requests, the plaintiffs' firms are seeking to pressure issuers to provide supplemental proxy disclosures to earn six-figure attorneys' fees.

The New Types of Proxy Litigation

Over 20 lawsuits have been filed – mostly by the same law firm, although others are now joining in – alleging that the boards of directors have breached their fiduciary duties by approving proxy statement disclosures that are insufficient to allow shareholders to make an informed decision when voting on the challenged "say-on-pay" or executive compensation plan proposals.

The plaintiffs have sought to enjoin votes on three types of proposals:

- The "say-on-pay" shareholder vote required by Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act;
- Proposals to increase the authorized number of shares under equity compensation plans; and
- Proposals to approve performance goals under incentive plans designed to comply with Section 162(m).

Most of these cases have been filed in New York and California State court under Delaware fiduciary duty law. Many issuers have successfully opposed attempts by shareholder-plaintiffs to enjoin the shareholder votes; others have settled for additional proxy disclosures and substantial legal fees for the plaintiffs' attorneys.

Say-on-Pay Litigation

In the original round of litigation relating to "say-on-pay," shareholder-plaintiffs sued derivatively to recover ostensibly "excess" compensation paid when the advisory "say-on-pay" votes were negative or won approval by small margins. The plaintiffs charged that the board's compensation decisions could not have been the product of a reasonable business judgment. Most of these claims have been dismissed on the grounds that the board of directors was fully independent and that the compensation decisions in question did not constitute corporate waste.

Those losses sent the entrepreneurial plaintiffs' bar back to the drawing board. In the next round of cases, shareholder-plaintiffs have sought to enjoin "say-on-pay" votes based on breaches of fiduciary duty arising from approval of allegedly materially inadequate proxy disclosures. Types of information alleged to have been wrongly omitted from proxy statements include:

- The manner of selection of the compensation committee's compensation consultants and determination of the fees paid to the consultants;
- A "fair summary" of analyses performed by the compensation consultant;
- Any peer group analysis performed by the company in setting compensation levels;

- Data used by an issuer to benchmark the issuer's executive compensation levels against those of peer group companies;
- Material market data about the issuer's peer group's compensation decisions;
- The relative weight attributed by the compensation committee to each factor it considered in setting compensation levels; and
- The basis for the issuer's distribution of long and short-term incentives in the plan.

Although shareholder-plaintiffs were able to obtain a few early settlements with companies *before* a decision on a preliminary injunction motion was issued, issuers that opposed motions to enjoin "say-on-pay" votes have been successful – either because their disclosures were consistent with industry standards (buttressed by expert witness and institutional shareholder declarations) or because the advisory nature of "say-on-pay" meant there was no "irreparable harm" to justify an injunction.

Litigation Relating to Amendments to Equity Plans and Executive Cash Incentives

The latest round of litigation by the plaintiffs' bar targets proposals seeking approvals for compensation plans where an injunction could have more "hold-up" value. In one case, plaintiffs were able to convince a California State court to enjoin Brocade Corporation's vote to increase the shares available for issuance under an equity incentive plan based on allegations that the proxy statement should have disclosed projections presented to the Brocade Board detailing expected future equity compensation obligations and expected future stock repurchase activities.

Brocade and similar cases attacking compensation plan proposals have focused upon alleged disclosure deficiencies, including:

- The basis for deciding upon on the number of additional shares to authorize for issuance under the plan;
- The reasons that issuance of additional shares is necessary;
- The potential dilutive impact on existing shareholders of the issuance of additional shares;
- The number of shares currently available for future issuance under the current equity plan; and
- Any projections of shares expected to be issued under the issuer's equity plans considered by the board of directors.

Faced with these claims, some issuers have elected to settle by providing supplemental disclosure and paying attorneys' fees. However, notwithstanding the *Brocade* result, almost all of the issuers that have opposed preliminary injunction motions to the point of a decision have been successful. As in the "say-on-pay" context, such issuers have defeated injunction motions by submitting substantial evidence, in the form of expert and fact witness testimony, that their disclosures complied with SEC rules, were consistent with industry standards and did not omit material information. Issuers have also been able to argue with success that votes to increase the shares available for compensation do not pose a risk of irreparable harm and thus do not warrant injunctive relief. Additionally, plaintiffs have dismissed a significant portion of these cases voluntarily, especially where they have failed to obtain a settlement or injunction prior to the shareholder vote. Although some cases are still pending following the denial of a preliminary injunction motion, plaintiffs may well not continue prosecuting these cases.

Finally, shareholder-plaintiffs have filed complaints seeking to enjoin votes to approve cash incentive compensation plans adopted pursuant to Section 162(m) of the Internal Revenue Code. That provision permits corporations to deduct executive compensation above a $1 million limit if the plan is approved by a shareholder vote and meets certain other requirements. Plaintiffs in such cases have alleged that the proxy disclosures failed to disclose with sufficient particularity the terms and conditions under which the incentive compensation would be paid. Most such cases have been dismissed either at the demand futility stage or for failure to allege sufficiently that the proxy disclosures were incomplete.

Key Takeaways for the 2013 Proxy Season

As companies prepare their proxy statements for the 2013 proxy season, there are steps corporate directors and executives can take to manage the risk associated with this latest wave of proxy litigation:

- No amount of additional disclosure can protect a company from being a target of this new wave of proxy litigation or the persistence of the plaintiffs' bar. Nevertheless, companies should review proxy disclosures carefully in light of the types of disclosures and omissions challenged most frequently. The review should also ensure full compliance with the applicable disclosure requirements, including under the federal securities laws. In addition to the proxy statement, this review should include any supplemental proxy disclosures companies may issue, including those issued in response to proxy advisory service recommendations, which may elicit increased scrutiny from plaintiffs' firms. Careful attention to proxy disclosures will, at the very least, improve a company's likelihood of success in opposing motions to enjoin shareholder votes on executive compensation issues.
- When commissioning or drafting all documents and reports used in compensation committee and board deliberations, including board materials, compensation consultant reports, and minutes, companies and their corporate secretaries or other personnel should be mindful that such materials will likely be discoverable in any subsequent litigation. This recent surge in shareholder litigation is a reminder that companies should review the coverages of their directors' and officers' insurance policies on a regular basis.

The long-entrepreneurial plaintiffs' shareholder bar has become increasingly creative at developing claims that entitle them to significant fees. The wave of litigation challenging proxy statement disclosures on compensation is just the latest example.