

# Corporate Governance Commentary

January 2013

## Defending the Latest Wave of Proxy Litigation: Say-on-Pay and Equity Plan Shareholder Class Action Injunction Lawsuits

### Introduction

The third proxy season of mandatory, nonbinding shareholder votes on executive compensation — so-called “say-on-pay” votes — is coming up quickly, and plaintiffs’ lawyers have hit the ground running with a new wave of class action injunction suits. Plaintiffs’ firms have announced investigations and suits against scores of public companies challenging proxy disclosures on executive compensation and stock equity plans. The litigation is modeled on merger injunction litigation, which is filed whenever a proposed public company sale is announced. The new brand of compensation injunction cases are lawyer-driven, fast paced and opportunistic. Heading into this proxy season, companies should be alert to these litigation developments and take steps to prepare a defense strategy in advance of a potential strike suit.

The first wave of say-on-pay lawsuits followed the 2011 proxy season when companies began complying with the Dodd-Frank Wall Street Reform and Consumer Protection Act requiring solicitation of a nonbinding shareholder say-on-pay advisory votes. Plaintiffs targeted companies with negative advisory votes and filed derivative suits claiming that the directors had breached their fiduciary duties to the company by adopting executive compensation plans notwithstanding the vote. These suits were almost uniformly dismissed because plaintiffs failed to rebut the presumption that the boards’ compensation decisions were valid business judgments and should not be second-guessed by the courts.

This time around, inventive plaintiffs’ firms are filing class action lawsuits before the shareholder vote and challenging the adequacy of proxy disclosures on executive compensation and equity plans. Plaintiffs seek to enjoin the votes until the company makes additional disclosures. Plaintiffs have had a few early successes in court, obtaining injunctions and settlements for additional disclosures and payment of attorneys’ fees. On the other hand, defendants have also achieved early successes in defeating injunctions, obtaining dismissals and encouraging plaintiffs to abandon meritless suits. These early results provide guidance for companies that want to plan ahead to position themselves for a strong defense and minimize business disruption if a suit is filed.

### Say-On-Pay Background and Derivative Litigation

The Dodd-Frank Act requires public companies to hold periodic say-on-pay advisory votes. 15 U.S.C. §78n-1(a)-(b). Congress recognized, however, that executive compensation is a matter of business judgment entrusted by state corporate law to the board of directors. Congress provided, that say-on-pay votes are merely advisory and do not override corporate compensation decisions or impose any new or different fiduciary duties on boards of directors. *Id.* § 78n-1(c) (“The shareholder vote . . . shall not be binding on the issuer or the board of directors of an issuer, and may not be construed . . . to create or imply any change to the fiduciary duties of such issuer or board of directors”).

Despite these statutory limitations on the effect of say-on-pay votes, plaintiffs tested the waters by filing shareholder derivative actions against boards of directors that declined to heed a negative advisory vote. These say-on-pay derivative suits alleged that the directors breached their fiduciary duties by approving “wasteful” and “excessive” executive pay. Courts dismissed the vast majority of these suits because plaintiffs failed to meet the prerequisites of shareholder standing to sue derivatively. Plaintiffs were not excused from their legal obligation to make a pre-suit demand on the board to bring the claims and failed to rebut the presumption that the boards made valid business judgments about executive compensation despite a negative advisory vote.<sup>1</sup>

Only one of these derivative cases survived a motion to dismiss. A federal court in the Southern District of Ohio held that the complaint alleged sufficient facts to rebut the presumption of valid business judgment in light of “overwhelming rejection” of the company’s executive compensation proposal in a nonbinding advisory vote. *NECA-IBEW Pension Fund v. Cox*, 2011 U.S. Dist. LEXIS 106161 (S.D. Ohio Sept. 20, 2011). The *Cox* decision was questioned, criticized and distinguished, including in the Northern District of Ohio and other jurisdictions.<sup>2</sup> The *Cox* court itself expressed second thoughts when it denied the plaintiff’s motion for a preliminary injunction, holding that the plaintiff had not shown a “strong likelihood of success on the merits.” *Cox*, 2011 U.S. Dist. LEXIS 109064, at \*4 (S.D. Ohio Sept. 26, 2011).

## Latest Wave of Proxy Vote Litigation

### *Plaintiffs’ Claims and Theories*

During last year’s 2012 proxy season, plaintiffs’ firms launched a new litigation strategy that is rapidly gaining momentum in this 2013 season. Plaintiffs began filing class action lawsuits seeking to enjoin the shareholder vote based on allegations that the disclosures about compensation-related proposals were deficient. The suits allege that the directors breached their state law fiduciary duties by making allegedly materially deficient disclosures to shareholders and that the company “aided and abetted” the alleged breach. Plaintiffs challenge disclosures soliciting nonbinding say-on-pay votes as well as binding votes to adopt or amend stock equity plans or increase authorized shares. Plaintiffs identify allegedly material omissions, allege that the disclosures are not sufficient to enable a fully informed shareholder vote and ask the court to enjoin the shareholder vote until and unless the company makes additional disclosures.

In most of these cases, Delaware state law governs the fiduciary duty claims because the corporate targets are incorporated in Delaware. Plaintiffs’ theory is that under Delaware law, or other applicable state laws, directors owe a fiduciary duty of candor to disclose all material facts when soliciting stockholder action. Given that the Delaware courts would come quickly to a consensus view in handling these suits, plaintiffs are seeking better traction outside of Delaware by filing suits in other state and federal courts, primarily in California and New York. Federal suits typically include claims for proxy violations under section 14 of the 1934 Securities and Exchange Act. 15 U.S.C. § 78n.

At this writing in January 2013, more than 20 suits have been filed and plaintiffs’ firms have announced investigations via press release and website postings of scores of other companies. The investigation announcements are designed to attract shareholders to volunteer as plaintiffs to spearhead the class action suits. Between October 1, 2012 and mid-January 2013, companies had filed approximately 225 proxies advancing say-on-pay proposals, more than 50 of which include equity plan proposals to increase the total number of authorized shares under the plan. One particularly active plaintiffs’ firm has announced investigations into the adequacy of disclosures by more than half of the companies with equity plan proposals.

The typical proxy vote injunction complaint alleges that the proxy should include additional information regarding an array of details, including judgments, estimates and opinions, roughly tracking the genre of disclosure claims often seen in merger injunction litigation. Examples of alleged omissions include:

- More Information about the Compensation Consultant
  - State what consulting and business services the compensation consultant provided to the company.
  - Explain why a company selected or changed its compensation consultant.

- More Economic Analysis concerning the Compensation Plans
  - Give a “fair summary” of the compensation consultant’s economic analysis or opinion provided to the board.
  - Explain the reasons behind the adoption of the particular mix of incentive and equity incentive compensation.
  - Explain the reasons for selection of particular companies as peers for purposes of benchmarking compensation.
  - Provide financial or compensation metrics concerning peer companies.
  - State the rationale behind the decision to benchmark or target compensation at a particular level.
  - Provide the criteria used to establish or shift target pay positioning of executive officers as compared to selected peer companies, and how those criteria are determined.
  - Explain the rationale behind severance agreements and their terms.
- More Information about Equity Plan Proposals
  - Explain how the board determined the number of additional shares to be authorized.
  - Provide a “fair summary” of any economist’s analysis or any opinion obtained in connection with the proposed plan.
  - Provide the projected stock grants or other projections considered by the board.
  - Quantify the equity value or cost of the issuance of the additional authorized shares.
  - Quantify the dilutive effect that the issuance of additional shares may have on shareholders.
  - Explain how the plan is in the best interests of the shareholders.
  - Quantify the company’s gross burn rate, net burn rate and overhang compared to the compensation peer group.
  - State whether the board will create a subcommittee to evaluate the risks and benefits for issuing the additional authorized shares requested.

## Plaintiffs’ Early Successes

Plaintiffs’ firms have obtained injunctions in two early cases and successfully negotiating settlements in several other cases that yielded plaintiffs’ attorneys’ fees.

In April 2012, plaintiffs obtained a preliminary injunction in proxy action against Brocade Communications Systems filed in Santa Clara County, California. There, the court enjoined a stockholder vote on Brocade’s proposal to restate its 2009 stock plan to increase the plan reserves by 35 million shares. Although the court rejected most of the plaintiff’s criticisms of the proxy disclosure, it agreed that stockholders were entitled to a “fair summary” of the compensation projections and analysis that the board considered in determining to propose a potentially dilutive issuance of 35 million authorized shares. *Knee v. Brocade Comm. Systems*, Case No. 1-12-CV-220249, Order (Cal. Sup. Ct. Santa Clara, Apr. 10, 2012) (“the court is persuaded that the shareholders are entitled to generally understand how the Board came to that number and why”). The Brocade defendants settled the case by agreeing to issue supplemental disclosures and paying attorneys’ fees of up to \$625,000.

In October 2012, plaintiffs obtained a preliminary injunction in an action against Abaxis Inc. in federal court in the Northern District of California. *St. Louis Police Retirement System v. Severson*, Case No. 12-cv-5086 (N.D. Cal., Oct. 3, 2012). In light of very unusual facts, the court enjoined a vote on a proposal to amend an equity incentive plan to increase the authorized number of shares and the award ceiling. The court permitted the vote to proceed seven days after Abaxis made additional proxy disclosures explaining the reasons for the proposal — including that the company had already violated the plan by issuing Restricted Stock Units in excess of the maximum allowed and thereby fell out of compliance with NASDAQ listing rules.

Companies in several other cases chose to settle with plaintiffs prior to any hearing on a preliminary injunction motion, including Martha Stewart Living Omnimedia, WebMD, H&R Block and Applied Minerals. The settlements involved agreements to make additional proxy disclosures and to pay plaintiffs' attorneys' fees in amounts between \$150,000 and \$350,000.

## Defendants' Early Successes

The defense side, on the other hand, has racked up more victories than plaintiffs in successfully defeating preliminary injunction motions. A strong, well prepared defense is key. Symantec Inc., for example, offered expert testimony by a Stanford law professor who compared disclosures of similar companies and opined that the information allegedly omitted from Symantec's proxy was not disclosed by the company's peers. *Gordon v. Symantec Corp.*, No. 1-12-cv-231541 (Cal. Sup. Ct. Santa Clara). Symantec's expert also opined that the sufficiency of disclosures for the advisory say-on-pay shareholder vote should not be measured by the same yardstick that courts use in reviewing disclosures soliciting a vote on a merger.

Microsoft likewise successfully defeated a preliminary injunction in November 2012 after offering similar expert analysis. *Gordon v. Microsoft, Inc.*, No 12-2-33448-0-SEA (Wash Sup. Ct, King County). Plaintiffs voluntarily dismissed their case before the injunction hearing. Defendants also defeated preliminary injunction attempts in actions involving The Clorox Company, AAR Corporation, and Ultratech and AmDocs.<sup>3</sup> These success stories show that many courts simply are not sympathetic to injunctions seeking to hold up annual shareholder votes on matters of ordinary corporate business.

**“These early results provide guidance for companies that want to plan ahead to position themselves for a strong defense and minimize business disruption if a suit is filed.”**

## Reviewing and Drafting Proxy Disclosure

Unfortunately, there is no clear pattern or explanation for which companies are being investigated or sued. As a result, every company with a shareholder vote in 2013 is at risk of being targeted. Companies need to be prepared to defend their disclosures.

At a minimum and as always, but especially this year, companies should pay scrupulous attention to compliance with SEC disclosure requirements applicable to proxy statements to ensure that all requirements are fully satisfied. Companies should take care that all proxy disclosures can be supported by the factual record, including compensation consultant reports and carefully drafted, up-to-date minutes of board and compensation committee meetings where directors considered actions and recommendations that will be disclosed in the proxies and presented for shareholder approval. Special attention should be paid to accurate disclosure of any material information provided to the board or compensation committee in connection with equity plan proposals and executive compensation decisions.

Beyond these good housekeeping measures, companies also should carefully review proxy disclosures, compensation discussion and analysis and say-on-pay and equity plan proposals in light of the various issues that have been targeted in the wave of investigations and class action suits (listed above). However, it is clear that there is no guarantee that simply adding more disclosure will fully protect a company from this wave of shareholder litigation. That said, companies should consider whether additional disclosure is appropriate or warranted, bearing in mind that creative plaintiffs' firms will always be able to come up with a wish list of new and different allegedly material omissions, and there is no certainty that additional disclosure will prevent such suits or investigations.

Thus far, plaintiffs' allegations targeting equity plan proposals have tended to be limited and potentially more easily addressed with quantifiable, non-speculative disclosure. For example, a company may wish to consider addressing the factors reviewed by the compensation committee or board in proposing to increase authorized shares to an equity plan, including the dilutive effect on shareholders and the company's burn rates and overhang compared to peer group companies. Companies should take special care, however, to avoid statements that can be read as implying promises about the future, such as exactly how long newly authorized shares will last. Plaintiffs'

allegations regarding say-on-pay disclosures tend, on the other hand, to include more subjective, non-quantifiable matters. Determining whether substantial additional disclosure is warranted may often be a closer question.

In short, this proxy season, companies should stay abreast of how the plaintiffs' suits are faring in the courts, how the allegations and complaints may be changing over time in response to court rulings, and how other companies are refining their proxy disclosures to address the changing landscape. Companies should review these issues with their disclosure and litigation teams and tailor their disclosure based on the materials reviewed by the company and its board of directors, the company's relationship with its shareholders and shareholder advisory groups.

## Defending This New Wave of Proxy Litigation

Ultimately, there is no blueprint that a company can follow to avoid being named in a proxy disclosure strike-suit. Companies can prepare in advance, however, to mount a strong defense and position to win the case or to settle on favorable terms. The following are steps that companies should consider in getting a jump start on litigation:

- Build a careful record in compensation consultant reports and board of director and compensation committee minutes supporting proxy disclosures and actions taken by the board and compensation committee, especially in seeking shareholder approval for additional equity plan shares. Ideally, the proxy disclosure regarding company recommendations and underlying considerations reviewed by the board or committee will tie directly to board and compensation committee minutes.
- Review the proxy and CD&A carefully to make certain that disclosures are supported by board minutes and materials in the written record. Good disclosure is the best defense against potential lawsuits.
- Engage experienced litigation counsel and disclosure counsel to proactively assist in reviewing proxy disclosures and planning for possible litigation.
- Ensure that the board of directors and senior management are aware of the potential for litigation, no matter what the company does or what the proxy says.
- Review the company's directors' and officers' liability insurance to assess coverage in the event of a suit.
- Monitor dockets and plaintiffs' press releases, and be prepared to react quickly if the company is sued or named in an investigation by a plaintiffs' firm.
- Reach out to institutional shareholders to develop advance support for compensation and equity plan proposals.
- Consider tasking legal counsel with engaging a legal expert knowledgeable regarding the Dodd-Frank Act and other laws and regulations affecting compensation disclosures and equity plan proposals.

## Endnotes

1. See, e.g., *Laborers' Local v. Intersil*, No. 5:11-CV-04093 EJD, 2012 U.S. Dist. LEXIS 30289, at \*18-25 (N.D. Cal. Mar. 7, 2012) (collecting cases); see also *Weinberg v. Gold*, 838 F. Supp. 2d 355 (D. Md. 2012); *Gordon v. Goodyear*, No. 12-C-369, 2012 U.S. Dist. LEXIS 97623 (N.D. Ill. July 13, 2012); *Swanson v. Weil*, No. 11-c-v-02142-WY-KLM, 2012 U.S. Dist. LEXIS 138182 (D. Colo. Sept. 26, 2012); *Iron Workers Local No. 25 Pension Fund v. Bogart*, No. 11-4604 PSG, 2012 U.S. Dist. LEXIS 81985 (N.D. Cal. June 13, 2012).
2. See *NECA-IBEW Pension Fund v. Cox*, No. 11-cv-451 (N.D. Ohio Dec. 5, 2011) (issuing order to show cause why earlier decision should not be vacated as the court lacked subject matter jurisdiction, and why plaintiff should not be sanctioned); *Plumbers Local No. 137 Pension Fund v. Davis*, 2012 U.S. Dist. LEXIS 5053, at \*14-15, \*23-24 (D. Or. Jan. 11, 2012) (*Cox* lacked subject matter jurisdiction and decision is distinguishable as applying Ohio, not Delaware, law); *Intersil*, 2012 U.S. Dist. LEXIS 30289, at \*18-19 n.5 (same).
3. *Mancuso v. The Clorox Co.*, No. RG12-65165 (Cal. Sup. Ct. Alameda County, Nov. 13, 2012) (Order); *Noble v. AAR Corp.*, No. 1:12-cv-07973 (N.D. Ill. Oct. 9, 2012) (Order); *Rice v. Ultratech, Inc.*, No. 112CV226520 (Cal. Sup. Ct. Santa Clara, July 16, 2012) (Order); *Joyce v. Amdocs Ltd.*, No. 650114-2012 (N.Y. Sup. Ct. Mar. 9, 2012) (letter to court regarding voluntary dismissal of case).

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