Executive Compensation Litigation: New Risk, New Strategies!

Brought to you by Winston & Strawn’s Executive Compensation and Employee Benefits and Securities Litigation practice groups
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Presentation Overview

I. Background
II. Executive Compensation Disclosure Litigation – By the Numbers
III. Substance of Claims: What are Plaintiffs’ Lawyers Targeting?
IV. Strategies and Rapid Response Team
V. Outlook for Future
I. Background
Executive Comp Shareholder Litigation 2.0: Annual Meeting Class Action Litigation

- When last we met, plaintiffs’ lawyers were still in the death throes of the last wave of executive compensation shareholder litigation.
  - “Sue on Pay”: Shareholder derivative suits challenging executive compensation decisions in the face of failed “say-on-pay” votes were roundly rejected for failure to plead so-called “demand futility” and based on the advisory nature of the shareholder vote.

- Now, plaintiffs’ lawyers – who know no end of creativity – have patented what may appear to be a new formula.
  - Shareholder class actions seeking to enjoin the annual meeting vote based on allegedly deficient disclosure relating to executive compensation proposals in the annual meeting proxy.
The Modus Operandi

- Really just old wine in new bottles.
- The Faruqi & Faruqi firm has taken a page straight from the playbook of the shareholder class actions that now plague over 90% of public company merger transactions.
  - Those cases typically seek to enjoin the shareholder meeting to vote on a merger by claiming, among other things, that the target board breached its fiduciary “duty of candor” by misstating or omitting material information from the proxy statement.
  - Plaintiffs’ goal is to use this threat to extract a quick settlement consisting of supplemental proxy disclosure and attorneys’ fees.
  - No coincidence that the specific lawyer at the Faruqi firm who is spearheading this latest wave of executive comp litigation is the driving force behind that firm’s merger class action practice.
**STEP 1:**

- Upon the filing of the annual meeting proxy, issue a press release announcing an “investigation” into whether the board breached its fiduciary duties in connection with amendments to its stock plan (e.g., “dilutive” share issuance) and/or the say-on-pay vote and the associated disclosures.
  - Otherwise known as “Trolling for a Plaintiff”
**STEP 2:**

- A few days later, send a letter to the GC providing some further detail and demanding a board “investigation” and a laundry list of supplemental proxy disclosure within five (5) days—“or else.”
  - The “or else” is a threat to sue to block the shareholder vote at the annual meeting.
    - Probing to see if the company is a “soft touch.”
    - AKA trying to bluff your way to a fee without having to spend much time or money.
**STEP 3:**

- Enter into settlement negotiations; avoid having to do any serious work; **OR**
- Watch as the company makes the disclosures you demanded without an agreed-upon settlement; ponder whether this “locks in” an attorneys’ fee; **OR**
- If *absolutely necessary* (i.e., the company calls your bluff), file a lawsuit to maintain your credibility; grumble to yourself about having to write a complaint.
**STEP 4:**

- Attempt to settle as quickly as possible after filing your case in order to avoid having to brief a PI motion and go to a hearing (more grumbling).

- If all else fails, go to Step 5.
The Dénouement

**STEP 5:**

**LOSE**

*(with rare exceptions)*

- Rinse.
- Repeat.
II. Executive Compensation Disclosure Litigation – By the Numbers
*By the numbers...

- At least 85 investigations to date.
- Of those 85, at least 22 have been filed as cases.
- Let’s break those down a little more...
*Number of Voluntary Dismissals

- We know Faruqi has voluntarily dismissed at least five of the cases.
*Motion Practice in these Cases*

- Courts have denied preliminary injunction motions in at least seven of these cases.
- Courts have granted at least two preliminary injunction motions.
*When have motions been denied?*

- **Gordon v. Symantec Corp.,** Superior Court of California, County of Santa Clara: No written opinion was issued but the PI motion was denied.
- **Noble v. AAR Corp.,** Northern District of Illinois: No written opinion was issued but the PI motion was denied.
- **Mancuso v. The Clorox Co., et al.,** Superior Court of California, County of Alameda: PI motion was denied with the Court particularly noting “the fact that the case was filed [less than a month before the shareholder meeting despite the fact that] the date of the shareholders’ meeting had obviously been known for some time.”
- **Wenz v. Globecomm Systems, Inc.,** Supreme Court of the State of New York: Court denied PI motion stating “the most critical factor militating against the granting of preliminary injunctive relief includes the notion that the movant can be fully recompensed by a monetary award or other adequate remedy at law.”
*Motions Denied: Continued*

- **Morrison v. The Hain Celestial Group Inc., et al.**, Supreme Court of the State of New York: Court denied PI stating that “significantly, the plaintiffs failed to meet their burden of showing that the information sought to be disclosed is material.”

- **Rice v. Ultratech, Inc., et al.**, Superior Court of California, County of Santa Clara: Court denied PI.

*When have motions been granted?*

- In *Knee v. Brocade Communications Systems*, the Superior Court of California, County of Santa Clara, concluded the proxy’s “Projections and Analyses” (future stock grants and planned share repurchases and their dilutive impact that served as basis for the Board’s decision to seek shareholder approval for issuance of 35 million additional shares) were material and should have been disclosed.

- In *St. Louis Police Ret. Sys. v. Severson, et al.*, the Northern District of California held that the proxy statement did not “accurately depict the purposes or effects of the proposed amendment to the 2005 Plan” and that the threat of an uninformed stockholder vote constituted irreparable harm.
We know Defendants have settled in at least eight cases. In five of these cases, we know Defendants paid attorneys’ fees and costs.
Unfortunately, we don’t have a great sense of how much these cases are settling for, as most of the case settlements have been confidential. However, we do know from SEC filings that in *Brocade Systems Inc.*, discussed above, after the PI was issued, Brocade agreed to make additional disclosures as well as pay $625,000 in attorneys’ fees and $6,996.23 in expenses.

- Obviously, the company was over a barrel at that point, so this is not indicative of the “going rate” for a settlement before taking an adverse decision, when plaintiffs face an 80% risk of losing.

The trend seems to be that Defendants pay “reasonable attorneys’ fees and costs”; all the shareholders get is additional disclosure. In other words, Faruqi is pocketing the money; shareholders aren’t seeing it.
III. Substance of Plaintiffs' Claims – "Tell Me More"
## What Materiality....

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<td>“substantial likelihood that a reasonable investor would consider [the fact] important in deciding how to vote.” <em>TSC Indus., Inc. v. Northway, Inc.</em>, 426 U.S. 438, 445.</td>
<td>“not every document reviewed by the board is material. Otherwise every book that's given to the board and every presentation made to the board would have to be part of the proxy...That certainly is not the law.” <em>Wayne Cnty. Emps.' Ret. Syst. V. Corti</em>, 954 A.2d 319, 332 (Del. Ch. 2008).</td>
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an omission where there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.” *Id.* at 449. 

Common Claims on Say-on-Pay Vote

- Failure to disclose a fair summary of compensation consultant advice, counsel, and analyses;
- Failure to disclose the amount of fees paid to the compensation consultant;
- Failure to disclose why the company switched compensation consultants from one year to the next;
- Failure to disclose consultant recommendations regarding changes to non-employee director compensation;
- Failure to disclose rationale for determining the applicable mix of executive compensation (base, bonus, and equity);
- Failure to disclose data (mean, median, range) on compensation elements for companies in the executive compensation survey group;
- Failure to disclose how the company’s gross burn rate, net burn rate, and overhang compare to the executive compensation survey group;
- Failure to disclose how the determination was made to increase the company’s stock ownership guidelines;
Say-on-Pay Claims (cont.)

- Failure to disclose how the determination was made to change the target pay positioning for executive officers from one percentile of the relevant market composite for salary (or other performance-based pay elements) to a different percentile;
- Failure to disclose why some companies were removed and why some companies were added from year to year in a company’s peer group;
- Failure to disclose why one executive’s compensation is comprised less of performance-based compensation than other named executive officers;
- Failure to disclose why the company entered into a severance agreement with certain named executive officers;
- Failure to disclose the criteria used by the company to form the termination schedule and severance pay of named executive officers; and
- Failure to disclose how the survey (e.g., Russell 2000) is used as a benchmark.
Court Responses to Say-on-Pay Claims

- Courts have generally focused on the advisory nature of the say-on-pay vote and lack of materiality of the requested information in rejecting motions for preliminary injunctions:
  - “Any claim of irreparable injury with respect to [say-on-pay vote], which concerns the compensation of executives, is purely speculative given the advisory nature of the vote.”
    - Morrison v. The Hain Celestial Group, Inc., New York Supreme Court for Nassau County
  - “This is a case regarding an advisory vote on compensation….should Plaintiff prevail, complete relief can be easily afforded and any perceived harm...undone. It is thus patent there is no risk of any interim, much less irreparable, harm.”
    - Mancuso v. Clorox Co., California Superior Court for Alameda County
  - One court, in ruling on the merits of the claims, stated that plaintiffs must bear the burden of showing how the allegedly missing information “would have been viewed as significantly altering the total mix of information already made available” to shareholders. Furthermore, the court referred to information requested by the plaintiffs as nothing more than “minute details.”
    - Gordon v. Symantec Corp., California Superior Court for Santa Clara County
CD&A Requirements

- Item 402(b) of Regulation S-K requires the CD&A to explain the material elements of a company’s compensation for its Named Executive Officers ("NEOs") by addressing the following questions:
  - What are the objectives of the company’s compensation programs?
  - What is each compensation program designed to reward?
  - What is each element of compensation?
  - Why does the company chose to pay each element?
  - How does the company determine the amount (and, where applicable, the formula) for each element?
  - How do each element and the company’s decisions regarding that element fit into the company’s overall compensation objectives and affect decisions regarding other elements?
  - Whether and, if so, how the company has considered the results of the most recent say-on-pay vote in determining compensation policies and decisions, including (if applicable) how that consideration has affected the company’s executive compensation decisions and policies.
In addition to answering the previous seven questions, the CD&A must also address any other information that is “material” to an investors’ understanding of the company’s executive compensation program.

Regulation 402(b)(2) provides 15 examples of items which should probably be discussed in a CD&A. However, the SEC notes that this list is neither meant to be exhaustive nor mandatory:

- The policies for allocating between long-term and currently paid out compensation;
- The policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation;
- For long-term compensation, the basis for allocating compensation to each different form of award (such as the relationship of the award to the achievement of the company’s long-term goals, management’s exposure to downside equity performance risk, the correlation between the cost to the company and the expected benefits to the company);
- How the determination is made as to when awards are granted, including awards of equity-based compensation such as options;
- What specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;
- How specific forms of compensation are structured and implemented to reflect these items of the company’s performance, including whether discretion can be or has been exercised (either to award compensation absent attainment of the relevant performance goal(s) or to reduce or increase the size of any award or payout), identifying any particular exercise of discretion, and stating whether it applied to one or more specified NEOs or to all compensation subject to the relevant performance goal(s);
CD&A Requirements (cont.)

- How specific forms of compensation are structured and implemented to reflect the NEO’s individual performance and/or individual contribution to these items of the company’s performance, describing the elements of individual performance and/or contribution that are taken into account;
- Company policies and decisions regarding the adjustment or recovery of awards or payments if the relevant company performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment;
- The factors considered in decisions to increase or decrease compensation materially;
- How compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (e.g., how gains from prior option or stock awards are considered in setting retirement benefits);
- With respect to any contract, agreement, plan, or arrangement, whether written or unwritten, that provides for payment(s) at, following, or in connection with any termination or change in control, the basis for selecting particular events as triggering payment (e.g., the rationale for providing a single trigger for payment in the event of a change in control);
- The impact of the accounting and tax treatments of the particular form of compensation (such as Section 162(m) of the IRC);
- The company’s equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership), and any company policies regarding hedging the economic risk of such ownership;
- Whether the company engaged in any benchmarking of total compensation, or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies); and
- The role of executive officers in determining executive compensation.
Common Claims on Stock Plan Proposals

- Failure to disclose a fair summary of compensation consultant advice, counsel, and analyses;
- Failure to disclose the number of shares currently available for future issuance under the current stock plan;
- Failure to disclose why implementing the stock plan proposal would be in the best interests of the shareholders;
- Failure to disclose how the company determined the number of additional shares requested to be authorized;
- Failure to disclose the potential equity value and/or cost of the issuance of the additional authorized shares;
- Failure to disclose the dilutive impact that issuing additional shares may have on existing shareholders;
- Failure to disclose the regulatory effects of the issuance of additional shares;
- Failure to disclose whether the board will create a subcommittee to evaluate the risks and benefits for issuing any additional shares requested;
Failure to disclose projected stock grants or any other projections considered by the company;

Failure to disclose why the company continues to grant shares to executives at an increasing rate;

Failure to disclose what the performance goals under the plan are (and that providing a list of performance measures from which the performance goals may be chosen is inadequate);

Failure to disclose the specific criteria used by the company in determining to implement the proposal;

Failure to disclose how the company determined to modify the “change in control” terms in the stock plan; and

Failure to disclose how any projected stock grants would affect the company’s capital structure.
Court Responses to Stock Plan Claims

Courts have generally focused on the lack of materiality of the requested information in rejecting plaintiff’s claims:

- “Omitted facts are not material simply because they might be helpful...the failure on part of the plaintiffs to demonstrate the materiality of the information sought undercuts the required showing of irreparable injury necessary to obtain interim injunctive relief.”
  - *Morrison v. The Hain Celestial Group, Inc.*, New York Supreme Court, Nassau County

- “The totality of the evidence submitted in support of the motion is an attorney declaration authenticating certain documents, but those materials do not by themselves prove a breach of fiduciary duty or demonstrate a likelihood of success on the merits. There is no shareholder or expert declarations in support of the moving papers explaining precisely what portions of the information presented to the Board would be material to a shareholder and why.”
  - *Mancuso v. Clorox Co.*, California Superior Court for Alameda County
Item 10 of Schedule 14A requires the following disclosures when a proxy statement contains a proposal seeking approval of a stock plan:

- Briefly describe the material features of the plan being acted upon, identify each class of persons who will be eligible to participate therein, indicate the approximate number of persons in each such class, and state the basis of such participation.
- If action is to be taken with respect to a material amendment, this item should be answered with respect to the plan as proposed to be amended and shall indicate any material difference from the existing plan.
- In a specified tabular format, the benefits or amounts that will be received by or allocated to each of the following under the plan being acted upon, if such benefits or amounts are determinable:
  - Each NEO
  - Executive Group
  - Non-Executive Director Group
  - Non-Executive Officer Employee Group
- If the benefits or amounts are not determinable, company should state the benefits or amounts that would have been received by or allocated to each of the above groups/individuals during the last completed fiscal year if such plan had been in effect.
- If the plan to be acted upon can be amended, otherwise than by a vote of securityholders, to increase the cost thereof to the registrant or to alter the allocation of the benefits as between the persons and groups specified above, state the nature of the amendments which can be made so.
Stock Plan Disclosure Requirements

- Additional Information Regarding Specific Plans Subject to Securityholder Action:
  - With respect to any specific grant of or any plan containing options, warrants, or rights submitted for security holder action, state:
    - The title and amount of securities underlying such options, warrants, or rights;
    - The prices, expiration dates, and other material conditions upon which the options, warrants, or rights may be exercised;
    - The consideration received or to be received by the registrant or subsidiary for the granting or extension of the options, warrants, or rights;
    - The market value of the securities underlying the options, warrants, or rights as of the latest practicable date; and
    - In the case of options, the federal income tax consequences of the issuance and exercise of such options to the recipient and the registrant; and
  - State separately the amount of such options received or to be received by the following persons if such benefits or amounts are determinable:
    - NEOs;
    - All current executive officers as a group;
    - All current directors who are not executive officers as a group;
    - Each nominee for election as a director;
    - Each associate of any of such directors, executive officers, or nominees;
    - Each other person who received or is to receive 5 percent of such options, warrants, or rights; and
    - All employees, including all current officers who are not executive officers, as a group.
  - Table required by Item 201(d) of Regulation S-K (shares subject to outstanding plans)
IV. Strategies and Rapid Response Team
Nothing can prevent the plaintiffs’ lawyers from filing a suit. However, in our world of executive compensation and litigation, many practitioners and companies are taking a few steps now, before filing their annual proxy statement.

- Attention to Drafting
- Preparation
Annual Meeting Disclosure Litigation – Planning (cont.)

- **First**, review and draft the executive compensation disclosures required in the proxy statement.
- As noted above, the plaintiffs’ lawyers have alleged many of the same disclosure deficiencies in many of their lawsuits.
  - Review a list of all of the disclosure deficiencies that have been alleged – and keep that in mind when drafting compensation disclosures.
  - Ensure compliance with disclosure rules (DO YOUR FORM CHECK!)
Second, take some preliminary steps toward assembling a rapid response team to (i) dissuade the plaintiffs’ lawyers from suing (the lawyers typically send a demand or informational letter before filing suit) and (ii) quickly defend the lawsuit if filed.

- No need to place dozens of lawyers on-call 24/7, but reach out to experienced counsel in this area with a cross-disciplinary team of lawyers dedicated to defending these lawsuits.
- Combine experts in shareholder litigation and compensation disclosure to handle these lawsuits.
- This team works and coordinates with the company in advance of it filing and is ready to go into action on a moment’s notice, if needed.
V. Outlook for Future
The Final Frontier?

- So, what’s next?

- As we mentioned in our last presentation, this segment of the plaintiffs’ bar is Darwinism in action: *Adapt and Survive*.
  
  - They proved us right by pioneering Executive Comp Shareholder Litigation 2.0 (Annual Meeting Litigation) when the Courts unceremoniously brought down the curtain on version 1.0 (“Sue on Pay”).
Now that their next-generation class action lawsuits are meeting a similar fate, plaintiff’s counsel appear to be returning to the vehicle of derivative suits challenging board approval of executive comp awards.

- The difference this time is that the basis for the claim is not that the award is at odds with a failed “Say on Pay” shareholder vote, but that it violated the Company’s stock plan itself.
The Final Frontier? (cont.)

- Keep an eye on your compensation plans and disclosures in these other areas:
  - Lawsuits over 162(m) “Slip-ups”
  - Lawsuits requesting compensation clawbacks (may explode after Dodd-Frank rules are fully implemented)
  - Lawsuits regarding limits to director compensation
  - Lawsuits stemming from a company’s failure to follow its own compensation plan
  - Say on Parachutes?
Questions?
Thank You.