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Viewpoint on Executive Compensation

Opinion Research **Alert**

Executive Compensation Litigation: Recent Cases and Efforts to Mitigate Potential Exposures

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During the last few years, executive compensation has been a favorite target of the plaintiff's bar in shareholder derivative litigation. Yet, despite its assertiveness, plaintiffs have experienced a relative lack of success. Wanting to take advantage of today's environment in which executive compensation practices are under continual scrutiny, plaintiffs have refined their approach and may be realizing the first-fruits of their efforts.

Recent executive compensation litigation efforts have emphasized:

- Say on Pay derivative actions;
- Direct actions against boards of directors which challenge supposedly inadequate proxy disclosure related to Say on Pay and equity compensation proposals; or
- Litigation related to Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code").

Say on Pay Derivative Actions

Unambiguous language contained in Dodd-Frank states that Say on Pay votes are "advisory" in nature and that the rules do not impose additional fiduciary burdens upon corporate directors. This, however, was not enough to prevent the first Say on Pay lawsuits, targeting companies that either failed, or just barely passed, their Say on Pay votes.

In virtually all of these cases, the courts have concluded that low levels of shareholder support are not sufficient to surmount a procedural hurdle and demonstrate an invalid use of a board's business judgment rule.

To anyone monitoring executive compensation developments, it is quite apparent that Say on Pay has brought forth a new era in dialogue among issuers, large shareholders and proxy advisory firms. While the dialogue may sometimes be difficult, its very existence can help fend-off lawsuits premised on an assertion that efforts to engage with board would be ineffective and futile.

Talking Points

- *Plaintiff's attorneys continue to refine their tactics in derivative shareholder suits.*
- *Initial suits, based on low shareholder Say On Pay support, have been largely unsuccessful due to difficulties demonstrating "demand futility" – or, demonstrating efforts to address concerns directly with the issuer would be futile*
- *Recent efforts targeting aspects of disclosures (i.e., adequacy and accuracy) have had only limited success in the courts*
- *Still, to mitigate potential exposure, issuers should:*
  - *Actively engage with investors and proxy advisors on areas of potential concern*
  - *Monitor disclosure trends and, as appropriate, adopt conforming changes*
  - *Ensure disclosures accurately disclose administrative practices*
  - *Consider expanded disclosures that respond to common evaluation criteria*

Actions Based on Inadequate Proxy Disclosure

Not being stymied by their repeated failures in their Say on Pay derivative actions, the plaintiffs' bar has shifted to alleging inadequacies in proxy disclosures regarding (i) Say on Pay resolutions and (ii) equity plan authorizations. These efforts have yielded only limited success.

In Knee v. Brocade Communications Systems, Inc., the plaintiff successfully petitioned the court to delay a vote to increase the number of authorized shares under its equity compensation plan pending disclosure of supplemental information. While the court granted the plaintiff's injunction, it did so narrowly, and only on the grounds that the projections regarding the number of shares to be issued in the future would be material to shareholders. Instead of fighting the injunction, the issuer chose to settle, making it difficult to assess the precedential value of this case.

Nevertheless, "victory" in the Brocade case emboldened the plaintiffs' bar to pursue actions based on inadequate proxy disclosure in other compensation-related matters. However, plaintiffs hit a roadblock in Gordon v. Symantec Corp. In this case, the plaintiffs challenged the adequacy of proxy disclosure related to a Say on Pay vote. The court ruled against the plaintiffs, concluding that disclosures conforming with regulatory requirements and industry-standard were adequate in light of the non-binding nature of the Say on Pay vote.

Code Section 162(m) Cases

Recently, a number of actions have been brought asserting that boards have failed to satisfy their fiduciary duties in various ways by paying compensation in excess of $1 million cap on executive compensation imposed by Code Section 162(m). The arguments in these cases include:

- the incentive plans established by directors failed to be Section 162(m) compliant;
- information contained in the proxy statement indicated that the relevant incentive plans were designed to be Section 162(m) compliant when, in fact, they were not;
- disclosure in the proxy statement indicated the compensation in question would be paid regardless of whether the payment was approved by the shareholders (which payment would then violate the performance-based compensation exception under Section 162(m)); and
- the proxy statement failed to adequately disclose the terms and conditions upon which the performance-based compensation would be paid.

For the most part, these derivative 162(m) cases have been dismissed due to difficulties overcoming the protections afforded by the business judgment rule. However, a small number of these cases have survived motions to dismiss. These generally concern the magnitude of potential pay opportunities:

- In Resnik v. Woertz, the court concluded that a plan that permitted awards of up to $90,250,000 per director and aggregate awards of up to $1,263,500,000 for all directors and executive officers as a group presented "elements of excessive compensation, director interestedness, and lack of candor."
- In another very recent case, the court refused to dismiss an action relating to a $120 million time-vested award to the CEO of Simon Property Group, noting that the company had previously stated that CEO pay would be tied to performance. According to the judge, the challenge to the time-vested only grant would be "hard for anyone to argue with."

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Despite prevailing in the vast majority of cases, issuers and boards continue to be targets of shareholder suits, raising the potential of significant legal defense expenses and, possibly, settlement costs.

Corporations and their directors are well advised to take various proactive measures to increase their chances of prevailing in these actions. Such measures include, but are not limited to:

- actively engaging with investors and proxy advisors regarding executive compensation programs and practices;
- monitoring emerging trends in executive compensation disclosures (e.g., concise executive summary, discussion of pay-for-performance linkages, realizable pay disclosures);
- reviewing disclosures to ensure they accurately describe programs and the policies guiding administration of those plans (e.g., whether the Board retains the right to award compensation that does not qualify for the performance-based exemption under 162(m));
- providing, in plans intended to be Section 162(m) compliant, that the cap on annual grants to affected executives will not be obviously excessive (as in the Resnik case);
- avoiding any disclosures which suggest the company will act based on the results of shareholder Say on Pay votes; and
- considering expanding disclosures relating to non-annual shareholder votes (such as equity plan authorizations) to include information similar to that agreed-to by the Brocade board of directors.

These measures cannot guarantee success, but may very well reduce the likelihood of successful shareholder suits against your board.

This Viewpoint is intended to inform compensation committees, executives and compensation professionals about developments that may affect their companies and should not be relied on as providing specific company advice, or as a substitute for legal, accounting or other professional advice.

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