



Recent Developments in Executive Compensation Litigation

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I. Introduction

In the current environment and in the wake of Dodd-Frank (and, before that, TARP) mandated rules requiring shareholder advisory votes on executive compensation, shareholder-plaintiffs have more aggressively challenged executive compensation decisions. In recent months, an active plaintiffs' bar has filed a series of cases, which generally fall into three broad categories:

- "say-on-pay" litigation;
- litigation relating to annual proxy disclosure, particularly with respect to equity compensation plans and say-on-pay proposals; and
- litigation relating to Section 162(m) of the Internal Revenue Code.

While most of these challenges have failed on substantive or procedural grounds or both, some have been more successful, and the plaintiffs' strategies continue to evolve. Notably, even unsuccessful claims can result in costly disruptions and/or reputational harm, especially where injunctions against annual shareholder meetings are threatened.

In this memorandum, we:

- present a brief review of the procedural and substantive standards generally applicable to executive compensation litigation;
- describe select recent cases; and
- offer a few tips to possibly minimize the risk of being subject to these claims or improve the chances of more efficiently rebuffing such claims.

II. Review of Procedural and Substantive Standards

A. Procedural Hurdles—Derivative Suits Require “Demand Futility”

Executive compensation-related lawsuits are often brought as derivative actions—*i.e.*, suits brought by a shareholder on behalf of the company, purporting to assert claims on behalf of the company. Generally under state law, including in Delaware, in order for a shareholder to bring a derivative suit, a shareholder must first either demand that the board of directors take action to initiate the suit or otherwise establish “demand futility.” In Delaware, to establish so-called demand futility, a shareholder must allege particularized facts that create a reasonable doubt as to whether:

- the directors are disinterested and independent; or
- the challenged transaction was otherwise the product of a valid exercise of “business judgment.”

Because shareholders bringing executive compensation-related derivative claims frequently cannot establish director interestedness, and because of the strong presumption in favor of the board's business judgment, many executive compensation lawsuits do not advance beyond the demand futility stage. And, while the relatively new wave of proxy-related disclosure cases features direct (not derivative) suits and therefore is not subject to these demand requirements, these cases have faced other challenges relating to the requirements for granting injunctive relief (*e.g.*, establishing irreparable harm), as discussed generally in Section III.B below. In addition to derivative lawsuits, plaintiffs frequently file putative class action lawsuits on behalf of a class of all shareholders of the corporation that is named as a defendant in the litigation.

B. Legal Bases—Same Name, Potentially New Game

The recent cases generally include claims that have served as the bases for plaintiffs' challenges for years:

- *Breach of Fiduciary Duty*—Many states' laws impose fiduciary duties of loyalty, good faith and care on directors and executive officers. The alleged breaches asserted in recent compensation litigation come in all shapes and sizes—from awarding particular types of equity compensation to failing to respond to a say-on-pay vote to making or not making certain disclosures in annual proxy statements.
- *Waste of Corporate Assets*—Many states' laws require that, when dealing with the assets of a corporation, directors engage in fair exchanges. Reflecting the strong presumption of the board's business judgment, however, the standard tends to protect directors even in circumstances where, with the benefit of hindsight, the transaction may have been imprudent, as long as the decision was made in good faith and the corporation received any substantial consideration in the exchange.
- *Unjust Enrichment*—Many states' laws prohibit directors from unjustly retaining some sort of benefit which results in a loss to shareholders. In the context of recent compensation litigation, this allegation is often based on the receipt of compensation obtained through a proxy statement containing inadequate disclosure.
- *False or Misleading Disclosure*—Section 14(a) of the Exchange Act and SEC Rule 14a-9 prohibit proxy statements which contain false or misleading statements with regard to any material facts, or which omit material facts necessary in order to make the proxy statement not false or misleading. Many states' laws can provide a corresponding cause of action via directors' fiduciary duties.

The first three claims (like the demand requirement) are often brought under the common law of the state in which a company is incorporated (which, in the majority of cases, is Delaware). Disclosure-based claims can be brought under the federal securities laws or state common law.

C. Jurisdiction—Learning the Geography

While compensation-related lawsuits generally are filed in the Delaware Court of Chancery and/or federal courts, the new say-on-pay lawsuits in which plaintiffs seek to enjoin annual shareholder meetings largely have been brought in state courts outside of Delaware (typically, in the state where the corporation-defendant is headquartered). Many of these courts are relatively inexperienced in litigation concerning executive compensation and corporate governance.

III. Select Recent Cases

A. Say-on-Pay Litigation

Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires issuers with a class of equity securities registered under Section 12 of the Securities Exchange Act of 1934 to include a separate shareholder resolution to approve executive compensation in their annual proxy statements at least once every three years. This say-on-pay vote is only advisory in nature, but, notwithstanding clear statutory language that the results of the vote may not be construed to create or imply any change to the fiduciary duties of boards or impose any additional fiduciary duties, a number of companies with low say-on-pay approval votes have been the subject of lawsuits alleging that the directors breached their fiduciary duties. For these derivative lawsuits, to establish demand futility, plaintiffs typically allege that

the result of the say-on-pay vote is evidence that the shareholders did not approve of the compensation decisions and that, combined with the company's poor performance, there are sufficient particularized facts to raise a reason to doubt that the board's compensation decisions were the product of valid exercises of business judgment. However, most of these claims have not advanced past the demand futility stage.¹

1. Low Say-on-Pay Approval Vote Likely Won't Excuse Demand

While plaintiffs have been creative in their arguments, the bottom line is that a low say-on-pay approval vote, whether alone or in combination with other factors, likely will not excuse demand.

The plaintiff in *Gordon v. Goodyear* argued that certain pay increases and cash bonus awards, which were made while Navigant Consulting was experiencing declining financial performance, were evidence of the directors' breach of fiduciary duties. A federal district court in Illinois applied Delaware law and dismissed the claim for failure to establish demand futility, finding that a say-on-pay approval vote of 45%, combined with the company's poor performance, was not sufficient to raise reasonable doubt that the transaction approving the compensation was the product of a valid business judgment.² It further reasoned that the plain language of Section 951 makes clear that the say-on-pay vote does not change or impose additional fiduciary duties.

Echoing the *Goodyear* decision, in *Swanson v. Weil*, a federal district court in Colorado applied Delaware law and concluded that a company's poor performance, taken with a failed say-on-pay vote, is insufficient on its own to establish demand futility. The plaintiff claimed that the board's approval of Janus Capital's 2010 executive compensation program, which allegedly raised its top executives' pay by 41%, coupled with a say-on-pay approval of 42% and a stock price decline of 7%, was a violation of the board's fiduciary duty to act in good faith. In rejecting the plaintiff's argument that the low say-on-pay approval was powerful evidence of a breach, the court reasoned that Section 951 explicitly declined to alter existing fiduciary duties and noted that most of the approved compensation related to a one-time executive signing bonus. Excluding this payment, the total compensation paid to the other four highest paid executives increased by less than 1%.

In *Haberland v. Bulkeley*, the plaintiff alleged that Dex One's directors breached their fiduciary duties when they failed to alter or amend the company's 2010 executive compensation plan, or to recoup any compensation paid pursuant to it, in response to a say-on-pay approval of 48%. A federal district court in North Carolina applied Delaware law and dismissed the case for failure to state a claim, again affirming that the board has no legal duty to respond to a negative say-on-pay vote. The court noted, however, that a board would be bound to take some action in response to a negative say-on-pay vote if it promised

¹ *Teamsters Local 237 v. McCarthy* was one of the earliest cases in which a motion to dismiss was granted for failure to establish demand futility. In that case, a Georgia state court applying Delaware law reasoned that Beazer Homes' adverse say-on-pay vote did not constitute evidence that rebutted the presumption of business judgment because the vote did not occur until after certain pay increases were approved, and thus, the directors could not have considered the results of the vote in granting them. The court also rejected the plaintiffs' claim that the "independent business judgment" of the shareholders sufficed to rebut the presumption because, the court reasoned, the Dodd-Frank Act expressly preserved the pre-existing framework concerning directors' executive compensation decisions.

However, four days later, in a case applying Ohio law, demand futility was established. The Ohio district court in *NECA-IBEW Pension Fund v. Cox* reasoned that Ohio does not analyze business judgment at the motion to dismiss stage, noting that in Ohio, "the business judgment rule imposes a burden of proof, not a burden of pleading." The parties settled after the decision.

² California law has been interpreted to be in line with Delaware law on this issue. In *Jacobs Engineering Group Inc. Consolidated Shareholder Derivative Litigation*, a California state court rejected the plaintiff's argument that the board's approval of a compensation plan that authorized significant pay increases for senior officers, despite say-on-pay approval of only 46.3%, was sufficient to establish demand futility.

to do so in the proxy statement. In this case, however, the board only explicitly agreed to “consider” a negative say-on-pay vote.

2. Board’s Interpretation of Pay-for-Performance Policy Trumps

Many of the say-on-pay lawsuits also allege that, when making a particular executive compensation decision, a board breached its state-law fiduciary duties by not adhering to the company’s pay-for-performance compensation plans or policies, as previously disclosed in the company’s proxy statement. To establish demand futility under this claim, the plaintiff must plead facts that create a reasonable doubt as to whether or not the board violated its own policies and metrics in awarding performance or as to whether or not the board applied the metrics in bad faith. Courts generally have held that disagreement over the interpretation of compensation plans’ provisions governing performance requirements is not sufficient to establish demand futility. In addition, the mere fact that a company granted incentive compensation outside of a shareholder-approved compensation plan should not excuse demand.

In *Gordon v. Goodyear*, where the plaintiff alleged that the directors violated Navigant Consulting’s policy of carefully linking executive pay to company performance, the court held that the plaintiff did not establish demand futility. The court reasoned that, in addition to focusing on the company’s performance and shareholder return, the compensation committee’s charter directed the compensation committee to consider a number of other factors when assessing the incentive component of executive compensation, including the value of similar incentive awards to CEOs at comparable companies and the awards given to the company’s CEO in past years. Furthermore, the court noted that the plaintiff only focused on certain financial metrics (the company’s negative 38.1% shareholder return and underperformance according to the S&P 500 index) and did not consider the additional factors disclosed in the company’s proxy statement.

Plaintiffs have brought similar allegations against companies for failing to follow pay-for-performance policies even where their say-on-pay vote results were positive. Such a claim was brought in *Freedman v. Bruch* against The Bank of New York Mellon, despite a say-on-pay approval of 79%, where the plaintiff alleged that the board violated the terms of its incentive plan by granting certain executive bonuses. The defendants countered that the bonuses in dispute were given to two executives for their roles in helping the company to achieve certain company priorities and for other accomplishments specific to each executive. A New York state court applied Delaware law, accepted the company’s statement that the awards were made outside the context of the incentive plan and affirmed the discretion of the board to grant bonuses designed to incentivize and retain the company’s talent.

In *Haberland v. Bulkeley*, the court dismissed the plaintiff’s claim that the Dex One directors breached their fiduciary duties by making materially false and misleading statements in the company’s 2011 proxy statement by describing the executive compensation plan as a strict pay-for-performance system. The court reasoned that the plan was not described as a strict pay-for-performance plan. Instead, the proxy statement referred to a number of plan objectives, including to enable the company to attract and retain the key leadership talent required to successfully execute its business strategy. Even assuming the plan was a strict pay-for-performance plan, the court explained, the plaintiff ignored the performance-based metrics disclosed in the proxy statement (ad sales grown, EBITDA and free cash flow, among others) and used his own criteria (*i.e.*, share price, the company’s predecessor’s Chapter 11 status and the fact that the New York Stock Exchange had suspended trading of the predecessor’s stock) for determining annual incentive compensation.

B. New Wave of Cases Based on Allegedly Inadequate Disclosures

Until recently, conventional litigation alleging inadequate disclosures in proxy statements stemmed from requests to shareholders to approve a proposed merger or acquisition of a public company. In such cases, shareholders typically allege that the disclosure regarding the proposed transaction provided to the

target's shareholders in the SEC filings (e.g., a proxy statement, a Form S-4 or a Schedule 14D-9) omit material information. Such shareholders seek to preliminarily enjoin the shareholder vote pending the issuance of supplemental or corrective disclosure. These cases frequently settle on the basis of supplemental disclosure.

Now, such lawsuits are no longer limited to merger proxy statements. Instead, the plaintiffs' bar is also focused on certain proposals included in annual meeting proxy statements, in particular:

- proposals to increase the number of shares available for issuance under equity plans; and
- say-on-pay proposals.³

Many cases have been filed to date, generally in state court (though some defendants have attempted to remove these lawsuits to federal court⁴). These new lawsuits typically allege that the companies' boards breached their fiduciary duties by approving purportedly deficient disclosure relating to such proposals. Generally, the plaintiffs request that the vote on the contested proposal be enjoined pending the issuance of supplemental or corrective disclosure. The costs associated with postponing the annual shareholders' meeting (or a vote on any particular proposal) can create incentives for defendants to settle quickly. These lawsuits have so far produced mixed results, and, at least with respect to say-on-pay proposals, the advisory nature of the say-on-pay vote and courts' focus on customary industry practices have created obstacles for plaintiffs.

1. **Brocade Communications—the Seminal Precedent?**

In one of the early lawsuits of its kind, *Knee v. Brocade Communications Systems Inc.*, the plaintiff **alleged** that Brocade's annual proxy statement did not include sufficient disclosure regarding a proposed increase to the number of authorized shares available for grant under the company's equity plan and requested that the Superior Court of California, County of Santa Clara, enjoin the vote on the proposal until the defendants remedied the defective disclosure. Specifically, the plaintiff **claimed** that the additional disclosure, among other things, should include the following information:

- the number of shares currently available for future issuance under the current equity plan;
- any projections considered by the company's board of directors concerning shares to be granted under equity plans in the future;

³ A third (though, so far, atypical) variety of such lawsuits challenges proposals for the approval of performance goals under incentive plans designed to comply with Section 162(m). In *Black v. Cincinnati Financial Corp.*, the plaintiff **sought** a preliminary injunction of the vote on the proposal to reapprove performance objectives under the company's equity compensation plan. The plaintiff's motions for a preliminary injunction on both his derivative and direct claims were **denied** by a federal district court in Ohio: in the case of the former claim, for failure to establish demand futility under Ohio law and, in the case of the latter claim, because the court found that the proxy statement was not false or misleading (and the plaintiff failed to establish that he would suffer an irreparable injury without the injunction). The case was subsequently dismissed.

⁴ At least one case suggests that this approach could yield strategic advantages. In *Boxer v. Accuray Inc.*, the defendant was successful in removing the case from the Superior Court of California, County of Santa Clara to the federal district court for the Northern District of California, Oakland Division. The plaintiff requested that the case be sent back to the state court, which request the district court ultimately granted after finding that the plaintiff's breach of fiduciary duty claim could be resolved without involving a "substantial, disputed federal question." The court also **denied** the plaintiff's motion for a preliminary injunction as moot in light of its determination that removal jurisdiction was lacking. The order to remove the case back to state court was entered on November 28, 2012. On November 30, 2012, Accuray held its annual meeting of shareholders and both proposals **passed**. On December 28, 2012, the plaintiff's lawyers filed a **declaration** in support of the plaintiff's request for dismissal (in the state court) and the case was ultimately dismissed on January 3, 2013.

- reasons that the company determined the number of additional shares requested to be approved for issuance;
- the potential dilutive impact of the issuance of additional shares; and
- a “fair summary” of any management and compensation consultant analyses provided to the company’s board of directors.⁵

Two days prior to the scheduled annual meeting, the court **issued** a preliminary injunction enjoining a vote on the proposal, reasoning that the projections and estimates considered by Brocade’s board in determining the number of additional shares to authorize would be material to a shareholder. The day before the annual meeting, Brocade entered into a **settlement order**, pursuant to which:

- Brocade proceeded to hold its annual meeting on April 12, 2012 as scheduled with respect to all proposals, except for the equity plan proposal.
- The vote on the equity plan proposal was adjourned until April 20, 2012⁶ and on April 12, 2012 Brocade **filed** revised additional soliciting materials disclosing the forecasted utilization rates with respect to Brocade’s proposal to increase the number of shares available for grant under the plan.
- Plaintiff’s counsel received an award of attorneys’ fees and expenses of up to \$625,000.

Following the court’s grant of the preliminary injunction, some commentators wondered whether this left companies with little choice but to settle in order to avoid the significant costs associated with postponing annual meetings or votes on discrete proposals.

2. Enter *Symantec*—A “Loser” for the Plaintiff’s Bar or Difference in Principle?

Brocade put pressure on companies to settle these types of litigations in order to avoid the risk of having a court preliminarily enjoin a shareholder vote.⁷ For example, **Martha Stewart Living Omnimedia** and **WebMd**,⁸ among others, agreed to issue supplemental disclosures regarding their proposals to approve amendments to their equity plans in advance of pending motions seeking injunctive relief. **H&R Block** similarly did so in respect of its proposal to increase the number of shares available under its equity plan

⁵ While Brocade did disclose how many shares were available for future awards under its current plan as of the end of its last fiscal year, it appears that the plaintiff wanted the number to be current as of the date of the proxy statement. The company also stated that it anticipated that the proposed number of additional shares, when combined with the remaining share reserve, would be sufficient to attract and retain key employees through at least April 2015. In addition, it provided its burn rates and overhang percentages for the previous three years and discussed how its plan conformed to “best practices” and was designed, among other things, to eliminate the “evergreen” provision.

⁶ The April 20, 2012 vote resulted in the approval of the equity plan amendment.

⁷ Interestingly, the same judge who ruled on the motion for a preliminary injunction in *Brocade* denied the plaintiff’s motion for a preliminary injunction in *Rice v. Ultratech, Inc.* In *Ultratech*, the plaintiff **sought** to enjoin a vote on a proposal to amend Ultratech’s certificate of incorporation to increase the number of authorized shares of Ultratech common stock from 40 million to 80 million, claiming that the company’s proxy statement contained severe and material disclosure violations, including regarding the dilutive impact of additional shares and how the board determined to request the additional shares. The court **denied** the plaintiff’s motion for a preliminary injunction, **distinguishing** the *Brocade* case on the grounds that, in *Brocade*, the company sought to **issue** additional shares under its equity plan, while Ultratech only sought to increase the number of **authorized** shares under its certificate of incorporation (thus, triggering different disclosure obligations) and finding that neither requirement for a preliminary injunction (*i.e.*, success on the merits and irreparable harm) was satisfied by the plaintiff. The proposal was subsequently **approved** by shareholders. The case is still pending in the Superior Court of California, County of Santa Clara.

⁸ WebMD also included additional disclosure regarding its say-on-pay proposal, even though the complaint did not relate to that particular proposal.

and its say-on-pay proposal, thereby seemingly extending the impact of *Brocade* beyond equity plan proposals.

However, in *Gordon v. Symantec Corp.*, which was **filed** in Santa Clara County before the same judge who granted the preliminary injunction in *Brocade*, the plaintiffs sought—but ultimately failed—to enjoin Symantec’s say-on-pay vote. The plaintiffs **claimed** that Symantec’s proxy statement failed to disclose essential information, including the following:

- the reasons that the company selected and/or changed its compensation consultant;
- a “fair summary” of the compensation consultant’s analysis or details of “unrelated consulting and business” services provided to the company’s board of directors;
- the reasons that the company selected particular companies as peers for purposes of benchmarking compensation;
- a “fair summary” of peer group analysis; and
- certain other benchmarking data.

Symantec retained Cornerstone Research and Professor Robert Daines of Stanford Law School, who submitted a **declaration** in support of the defendant’s motion in opposition to the preliminary injunction, concluding that Symantec’s disclosures were consistent with customary industry standards⁹ and complied with regulatory requirements. On October 17, 2012, the court, citing Professor Daines’ analysis and relying on information contained in the defendants’ opposition brief, **denied** the plaintiff’s motion for a preliminary injunction, finding no precedent for enjoining an advisory say-on-pay vote or imposing additional disclosure requirements that neither Congress nor the SEC had adopted. The court distinguished the non-binding nature of the say-on-pay vote from the amendment of an equity plan (as in *Brocade*) or the vote to approve a merger.

The *Symantec* result was subsequently replicated in several other cases and jurisdictions. In *Noble v. AAR Corp.*, for instance, the plaintiff **alleged**, among other things, that AAR’s proxy statement omitted material information regarding peer companies and fees paid to the compensation committee’s compensation consultant. On October 9, 2012, the federal district court for the Northern District of Illinois **denied** the plaintiff’s motion for an injunction on the ground that the say-on-pay vote was merely advisory and, therefore, did not generate the level of irreparable harm necessary to issue a preliminary injunction.

3. Life After *Symantec*—What Now?

What remains to be seen after *Symantec*¹⁰ is whether *Brocade* will govern the analysis of equity plan proposals or whether *Symantec*’s “customary industry standard” analysis will be extended even to binding proposals, such as proposals to amend equity plans.

⁹ Professor Daines reviewed the proxy statements of 34 companies, consisting of (1) the peer group companies that Symantec and its compensation advisor used for benchmarking executive compensation and (2) the “top 26 high technology hardware and software companies in Silicon Valley (as determined by the San Jose Mercury News ranking of the Silicon Valley 150).”

¹⁰ While the plaintiff in *Symantec* lost the motion for a preliminary injunction, the case is still pending. On November 20, 2012, the defendants filed a **demurrer** to plaintiff’s class action complaint, claiming that the complaint failed to state a legal cause of action. The defendants **argue**, among other things, that, as Symantec’s say-on-pay proposal was “overwhelmingly” approved by shareholders (receiving approximately **96.96%** in favor of the proposal), the claims asserted by the plaintiff are no longer direct (*i.e.*, belonging to individual shareholders) and are instead derivative (*i.e.*, belonging to Symantec) and, therefore, the plaintiff should be subject to the pre-suit demand requirement or be able to demonstrate why demand is excused.

For example, when Clorox was sued in *Mancuso v. The Clorox Company* on October 10, 2012, in the Supreme Court of California, County of Alameda, the plaintiff combined the two theories and **sought** to enjoin the company's say-on-pay vote and the vote on amending the company's equity plan due to what were alleged to be severe and material disclosure violations. Professor Daines was retained by the defendants, and he again **concluded** that the additional disclosures requested by the plaintiff were unlikely to be important to economically rational shareholders and that the company's existing disclosures regarding say-on-pay and the equity plan were consistent with industry custom and practice (based on Professor Daines' review of a "significant number" of proxy statements for similar companies¹¹).

On November 13, 2012, the Clorox court **denied** the plaintiff's motion for a preliminary injunction citing the plaintiff's "meager evidentiary presentation," versus the defendants' "substantial evidence" that the information the plaintiff claimed should have been disclosed was immaterial. More importantly, the court found that there was no threat of irreparable harm, because, unlike a merger or takeover situation which "would require the court after a trial on the merits to try to 'unscramble the eggs' if the plaintiff were to prevail," both shareholder actions could be voided by court order and new votes could be held.¹²

Similar allegations were **set forth** in the *Wenz v. Globecomm Systems Inc.* complaint filed on October 11, 2012. On November 14, 2012 (the day before Globecomm's annual shareholders' meeting), the state court in Suffolk County, New York, **denied** the plaintiff's motion for a preliminary injunction with respect to Globecomm's equity plan and say-on-pay proposals, because, among other grounds, the disclosures requested by the plaintiff (e.g., a fair summary of the compensation consultant's analysis, projected stock grants, dilutive impact and certain peer group data) were not material.

(i) *Equity plans that are broad-based might be easier to defend.*

In *Gordon v. Microsoft Corp.*, filed on October 11, 2012, the plaintiff **alleged** that Microsoft's proxy statement failed to provide adequate disclosure concerning the information the board of directors considered in making its say-on-pay recommendation, as well as the reasons for, and effects of, the company's proposal to reserve additional shares for issuance under its 2003 Employee Stock Purchase Plan ("ESPP"). In its **opposition to plaintiff's motion for a preliminary injunction**, the company emphasized that the three leading proxy advisory services (Glass, Lewis & Co., Institutional Shareholder Services and Egan-Jones) had recommended for approval by the shareholders the two proposals in question and that one of its largest shareholders (the California State Teachers Retirement System) confirmed that Microsoft's proxy disclosures were "sufficient . . . to understand [the proposals]." In addition, Microsoft (like Symantec and Clorox) retained Professor Daines, who **concluded** that there was no basis for the additional disclosures that the plaintiff demanded, finding that Microsoft's disclosure was consistent with that of its peers.

Microsoft argued that:

- a non-binding say-on-pay vote could not possibly cause the plaintiff to suffer a substantial injury; and

¹¹ Professor Daines reviewed (1) with respect to Clorox's say-on-pay proposal, the proxies of (a) 13 consumer products peer firms identified in Clorox's proxy statement and (b) another 22 similar firms (matched by size and industry) conducting say-on-pay votes and (2) with respect to Clorox's equity plan proposal, the proxy statements of 30 similar firms seeking to increase the number of shares available under equity plans consisting of (a) seven sample firms used in his review of say-on-pay proposals and (b) 23 other companies with a market capitalization close to that of Clorox.

¹² On December 3, 2012, the plaintiff filed an amended class action complaint seeking, among other things: (1) issuance of a new, supplemental proxy statement that would include the material information requested by the plaintiff, (2) a new annual meeting to vote on the say-on-pay and equity plan amendment proposals after a new, supplemental proxy statement is disseminated, (3) rescission of the votes on the company's say-on-pay and equity plan amendment proposals until the new, supplemental proxy statement is disseminated and (4) potentially, rescissory damages. The next court appearance is scheduled for June 2013.

- “[r]eplenishing a stock purchase plan in existence for twenty years, which allows employees to buy stock at a 10% discount, could not conceivably cause irreparable harm to shareholders of one of the world’s most valuable companies, with 8.4 billion shares outstanding.”

Microsoft further noted that, if necessary, the court could unwind the ESPP decision in due course, require new disclosures and mandate a new vote, and that it did not need to issue an injunction to enjoin the vote in progress. The company argued that the facts in *Brocade* were distinguishable because *Brocade* “involved a stock plan that provided for outright awards of large amounts of stock to executives at no cost—not a standard ESPP,” and the plaintiff in *Brocade* did not attack a similar ESPP proposal. On November 20, 2012, the lawsuit was **dismissed** with prejudice. No details regarding the basis for dismissal were included in the order (although Microsoft’s deputy general counsel recently shared that the plaintiff offered to voluntarily dismiss the lawsuit after Microsoft indicated that it was not willing to settle).

(ii) *Say-on-pay v. equity plan proposals.*

What the above cases appear to indicate is that, while defendants are more likely to defeat a motion for a preliminary injunction seeking to enjoin a say-on-pay vote, they may have more difficulty doing so with respect to proposals to amend equity plans. Given that the amendment of an equity plan requires a binding shareholder vote, a shareholder-plaintiff may have a stronger argument as to the potential for irreparable harm if the vote is taken without full disclosure of all material information.

As a general matter, it appears that the more a company’s disclosure is in line with customary industry practice (and, perhaps, the less executive-friendly the equity plan amendment is or where dilution is not an issue), the less likely a plaintiff will be able to succeed in obtaining a preliminary injunction. For instance, in *St. Louis Police Retirement System v. Severson*, the plaintiff **sought**, among other things, to enjoin Abaxis Inc.’s vote on an amendment to its equity plan. This amendment sought to eliminate the restricted stock limit under the company’s equity plan as the company granted and ultimately issued common stock in settlement of restricted stock units in excess of the restricted stock limit. The plaintiff **claimed** that the proxy disclosure was misleading as to, among other things:

- the bases for the compensation committee’s decision to eliminate the restricted stock limit (e.g., that the company had already violated the equity plan by dramatically exceeding the restricted stock limit);
- the company’s admission that it violated the equity plan by exceeding the restricted stock limit; and
- the number of restricted stock units that the company has granted beyond those that could be settled in accordance with the restricted stock limit and the effect of the proposed amendment on those excess restricted stock units (notably, many of the excess equity grants were made to executives of the company).

The district court in the Northern District of California **granted** in part the plaintiff’s motion for a preliminary injunction because the company’s annual proxy statement did not explain the consequences of failure to approve the proposed amendment (e.g., state that the proposed amendment is necessary to re-achieve compliance with Listing Rule 5635(c) of NASDAQ). Even though this had previously been disclosed on a Form 8-K, the Form 8-K was not incorporated by reference into the proxy statement. The court found that this information was material to shareholders and enjoined the shareholder vote on the amendment until additional disclosure could be provided. The company filed the **disclosure** on October 26, 2012, and the proposal passed on November 8, 2012. The motion to dismiss this case is currently pending. While this case came after *Symantec*, it is distinguishable given its unique facts (*i.e.*, eliminating a very specific provision in the plan was disproportionately beneficial to the company’s executives who held significant awards under the plan in excess of the restricted stock limit).

(iii) *Not-so-certain future.*

At the time of this writing, several other cases are still pending in state and federal courts. And, while it is not possible to predict the outcome of these cases, barring unique facts, it appears that the plaintiff's bar might not be as successful in this "new wave" of compensation-related litigation as the *Brocade* case first led some to believe.

C. Section 162(m) Litigation

Section 162(m) generally limits the tax deduction a publicly held corporation may take for compensation paid to covered executives that is in excess of \$1 million per year. However, an exception to the rule provides that the limit does not apply to performance-based compensation pursuant to a shareholder-approved plan that has one or more performance goals and meets certain additional criteria.

While Section 162(m)-related claims are not new,¹³ they have proliferated in recent months. In Delaware alone, we are aware of at least seven cases filed during 2011 and 2012, several of which are discussed in more detail below.

Plaintiffs have pursued both derivative and direct theories, claiming, for example, breach of fiduciary duties, waste and unjust enrichment where corporations have failed to take advantage of the exception to non-deductibility under Section 162(m) or false or misleading disclosure in connection with statements made in public filings in respect of compliance with Section 162(m). Notably, such claims are brought without the Internal Revenue Service having challenged the deductibility of the awards. Recent claims include the following allegations, among others:

- the directors failed to structure or operate a plan in compliance with Section 162(m);
- the compensation committee's use of discretion to determine awards under an incentive plan violated the terms of the plan and/or relevant regulations;
- the proxy statement indicated that the plan was designed to comply with Section 162(m) when the plan was somehow non-compliant;
- the proxy statement indicated that the compensation would be paid regardless of shareholder approval, in violation of the regulations implementing Section 162(m); and
- the proxy statement failed to disclose, with meaningful specificity, the material terms and provisions under which the incentive compensation would be paid.

With several exceptions, these claims generally have not advanced past the motion to dismiss stage due to failure to establish demand futility. The few claims that have been permitted to move forward do not differ significantly in terms of legal theory or factual background from those that have been dismissed and therefore introduce some uncertainty as to the future of these types of suits.

¹³ One of the earliest such cases was decided nearly a decade ago by the Third Circuit. In that case, *Shaev v. Saper*, the plaintiff alleged a number of deficiencies in Datascope Corporation's proxy statement, including that it falsely represented that the president's bonus payment would be deductible under Section 162(m) if approved by shareholders. The court found that the plaintiff sufficiently pled that the directors were interested and held that the demand requirement had been met. However, the suit settled before trial. Another older case is *Seinfeld v. Barrett*, which came before the District Court of Delaware in 2006. In that case, the court denied the defendants' motion to dismiss the claims for failing to make demand (finding that the plaintiff had pled facts sufficient to raise a doubt that the compensation actions were taken honestly and in good faith), but also denied summary judgment in favor of the plaintiff. The suit was eventually settled.

1. Hitting the Demand Futility Wall

A representative recent case is *Freedman v. Adams*, a derivative suit on behalf of XTO Energy, which alleged waste and breach of fiduciary duties, as well as misleading disclosure, in connection with bonus payments that were allegedly not deductible under Section 162(m).¹⁴ To establish demand futility, the plaintiff proffered a number of theories as to why the directors were interested or acted in bad faith, each of which the Delaware Court of Chancery rejected. In response to the plaintiff's argument that the failure to minimize taxes itself constituted bad faith, the court held that there was no general fiduciary duty to minimize taxes.¹⁵ The court also noted that if the board believed in good faith that implementing a Section 162(m) plan would constrain its discretion to make compensation decisions, sufficient consideration existed for its determination to forgo the deductions (and therefore, the plaintiff's waste claim failed). The court emphasized that its "deference to directors' business judgment [was] particularly broad in matters of executive compensation."

The plaintiff also claimed that the company's proxy statement had materially misstated that the company intended to monitor the compensation paid to its executive officers in light of the provisions of Section 162(m), when, in fact, the company had no Section 162(m) plan at the time. In the context of other statements in the proxy, the court found that a reasonable investor would not have interpreted such disclosure to mean that the company had a Section 162(m) plan in place and dismissed the claim.¹⁶

Seinfeld v. Slager, a case involving five distinct waste claims based on compensation actions taken by the board of Republic Services, hit a similar procedural impasse this year. The Delaware Court of Chancery dismissed all of the Section 162(m)-related claims due to the failure to establish demand futility.¹⁷ In affirming that the decision to "pursue or forgo tax savings" was generally a business decision for the board and that there was "no general fiduciary duty to minimize taxes," the court observed that there were a variety of reasons why a corporation might choose or not choose to pursue tax savings.

In a third case decided in late August 2012, the federal district court in Delaware refused to excuse the demand requirement in a derivative suit on behalf of *AK Steel*. The complaint alleged that the company's compensation plans were defective:

¹⁴ Though the plaintiff's complaint was subsequently rendered moot by the board's establishment of a Section 162(m)-compliant plan, the court had the opportunity to address the plaintiff's claims in the context of a motion for attorney's fees and expenses and dismissed all claims relating to Section 162(m).

¹⁵ The court, however, left open the theoretical possibility that under some hypothetical set of circumstances, the overpayment of taxes, or a poor tax strategy, could be the result of a breach of fiduciary duty or constitute waste.

¹⁶ The plaintiff filed an appeal with the Supreme Court of Delaware (with respect to the waste claim only). On January 14, 2013, the Supreme Court **upheld** the Chancery Court's ruling on the plaintiff's claim, reasoning that (1) the complaint had failed to allege that the bonuses paid to XTO's executives actually would have been deductible under such a plan, and (2) the board's decision to "sacrifice some tax savings in order to retain flexibility in compensation decisions [was] a classic exercise of business judgment."

¹⁷ The plaintiff's only **claim** to survive the motion to dismiss involved allegations that the compensation committee's decision to award to all but one of the defendant directors time-vesting restricted stock units worth \$743,700 in 2009 and \$215,000 in 2010 constituted excessive compensation, waste and unjust enrichment. The court distinguished the facts at issue from *In re 3COM Corp. Shareholders Litigation*, in which the directors received the benefit of the business judgment rule, reasoning that, despite shareholder approval, the equity plan at issue lacked sufficient specificity to place a meaningful limit on the board's discretion to make the awards. After finding that the directors were interested in the transaction, the Delaware Court of Chancery held that demand was excused and that the more stringent "entire fairness" standard of review would apply to the claim. The court, however, refused to find demand excused with respect to the board's decision to grant time-vesting units to employees, although the directors participated in the same plan, because the claim stemmed from the board's decision to make a certain type of award to employees generally and therefore, with respect to that particular transaction, the directors were not interested.

- first, in giving the compensation committee discretion to increase the amount of compensation payable after one quarter of the performance period had elapsed, in violation of Section 162(m); and
- second, because shareholders were threatened in the proxy statement that if they did not vote to approve the performance goals under the plans, the compensation would nevertheless be paid.

With respect to the latter, the court noted that, while disclosure-based claims were generally not subject to the demand requirement because they are typically brought as direct claims, a derivative claim based on a proxy statement nondisclosure required particularized facts to establish demand futility that the plaintiff had failed to produce. The court further observed that the board's failure to follow the terms of an approved compensation plan was insufficient on its own to excuse demand without additional facts pointing to directors' knowledge and intent.¹⁸

2. *Resnik and Hoch—An Interesting Wrinkle*

However, in a minority of cases, Section 162(m)-related claims have survived a motion to dismiss. In *Resnik v. Woertz*, the federal district court in Delaware refused to dismiss the plaintiff's derivative claims for waste, breach of fiduciary duty, unjust enrichment and inadequate disclosure.¹⁹ Archer-Daniels-Midland's plan permitted awards of up to \$90,250,000 per director and the aggregate payments to directors and executive officers could have reached up to \$1,263,500,000 (which indicated, in the *Freedman v. Adams* court's view, that the forgone tax deductions in *Resnik* were of "a completely different magnitude" and that there were "elements of excessive compensation, director interestedness, and a lack of candor" not present in *Freedman*).

Furthermore, the plaintiff asserted a myriad of inadequate disclosure claims, some of which the Delaware district court found lacked materiality, but many of which survived the motion to dismiss. Of note are the following allegations relating to the company's Section 162(m) compliance:

- the proxy statement had been misleading in representing that the plan was designed to be performance-based and comply with Section 162(m) when the tax deductibility of the awards under the plan had previously expired; and
- the proxy statement had been misleading in failing to disclose with specificity the performance goals under which the compensation would be paid, where the plan and the proxy statement listed a series of performance goals but the ultimate awards were made in the discretion of the compensation committee.

The court specifically noted that such omissions were material in that they could "very likely preclude" the deductibility of the awards under Section 162(m). Finding that the substantial financial interest the directors had in the outcome of the shareholder vote was sufficient to create a reasonable doubt as to their independence and disinterestedness, the court held that the demand futility requirement had been met.²⁰

¹⁸ The plaintiff was granted leave to amend the complaint, which she did on September 4, 2012. A second motion to dismiss is pending as of the date of this writing.

¹⁹ The plaintiff's direct claim for false or misleading disclosure under the Exchange Act was dismissed due to the plaintiff's inability to meet a heightened pleading standard under the Private Securities Litigation Reform Act.

²⁰ Following mediation, the parties reached an agreement in principle as to settlement. The plaintiff has filed an [amended complaint](#) pending the court's ruling on the proposed settlement.

Hoch v. Alexander is another somewhat recent example in which derivative claims on behalf of Qualcomm relating to Section 162(m) survived a motion to dismiss. Qualcomm's proxy statement, through which the company sought approval for an amendment of an equity plan, stated that certain types of equity granted by the compensation committee qualified as performance-based compensation, and that other awards subject to performance goals might also qualify. The proxy statement also disclosed that, if shareholders did not approve the plan, the amended plan would not be implemented and the prior plan would remain in effect. Therefore, the plaintiff argued, because the performance-based compensation would be paid under the existing plan regardless of whether the amended plan received shareholder approval, no shareholder vote would make the payments tax-deductible and the directors had breached their fiduciary duties and committed waste as a result. Though it dismissed the plaintiff's direct claim due to the failure to establish a link between the alleged misstatements and any actual economic harm, the Delaware district court found that the plaintiff had met its burden of establishing demand futility because of the directors' interests in the payments under the equity plan.²¹

In both *Resnik v. Woertz* and *Hoch v. Alexander*, the fact that at least a majority of directors was eligible to participate in the compensation plans led the Delaware district court to conclude that demand was excused. However, more recent cases have analyzed the issue in a more nuanced fashion. For example, both *Seinfeld v. Slager* and *Abrams v. Wainscott* addressed the demand futility requirement separately for each transaction and concluded that, while the directors were entitled to payments under the compensation plans at issue, they were not interested in the challenged transaction itself (other than, in the case of *Seinfeld v. Slager*, the awards to directors).

3. The Suits Keep Coming—The *Viacom* Complaint

Though most Section 162(m) claims have met with limited success, plaintiffs' firms continue to bring suits against new defendants—Allergan, ConocoPhillips and, most recently, Caterpillar have all been engaged in Section 162(m)-related litigation over the past year. In addition, a **complaint** filed in August 2012 alleges that the directors of Viacom breached their fiduciary duties and committed waste by using subjective qualitative factors to determine a portion of bonus payments and positive discretion to increase payments, each of which would be in violation of Section 162(m), under a short-term incentive plan purportedly designed to qualify for the performance-based exception to non-deductibility.²² The defendants filed a **motion to dismiss** in late October 2012, arguing that the plaintiff failed to adequately establish that demand was excused and that the directors had no general duty to minimize taxes under Delaware law. The defendants maintain that the discretion exercised by the compensation committee was used only to reduce the maximum earned award authorized under the plan, which they noted would be consistent with the terms of Section 162(m) and the plan itself.²³ At this time, no hearing has been scheduled on the motion to dismiss.

²¹ Nearly a year and a half after the court issued its opinion, the plaintiff filed an amended complaint that included many of the same claims that the court had previously addressed, plus a host of new, but related, claims. The defendants filed another motion to dismiss which indicated, among other things, that the Internal Revenue Service had issued an Issue Resolution Agreement stating that Qualcomm's 2011 shareholder approval was fully compliant with the requirements of the relevant regulation under Section 162(m).

²² The plaintiff also argued that the defendants had breached what the plaintiff interpreted to be statutory duties under Section 162(m) to provide holders of non-voting shares the right to vote on whether to approve the plan. In their motion to dismiss, the defendants dispute the notion that there is any duty, statutory or otherwise, to permit holders of non-voting shares to vote to approve the plan.

²³ In other words, the company's bonus plan functioned as a "plan within a plan" whereby one "outer" plan defined the maximum payments to employees using performance metrics, which payments were then whittled down in the "negative discretion" of the (*cont.*)

IV. Steps to Potentially Minimize Your Litigation Exposure

Despite the fact that many executive compensation-related lawsuits have been frustrated by the significant hurdles that accompany these types of claims, there are considerable costs associated with discovery and protracted litigation (even where defendants succeed) or having to postpone or hold a separate shareholder vote (where plaintiffs succeed on some or all of their claims). Moreover, the plaintiffs' bar does not appear to be slowing down in their efforts to pursue these claims. While there is no combination of steps that a company can take to fully insulate itself from litigation risk, there are a number of precautionary measures that can be taken to limit the likelihood of being sued, to increase the likelihood of success in defending against such lawsuits and/or to manage the risks of plaintiff activity. These steps include:

- Keep the compensation committee informed about developments with respect to these types of lawsuits so that the committee may incorporate relevant considerations stemming from such developments into its decision-making process.
- Be wary of making statements promising that any sort of definitive action will be taken depending on the results of a say-on-pay advisory vote.
- When describing a program as a “pay-for-performance” program, ensure that the program is actually implemented and that the metrics and other factors used to evaluate “performance” are properly described.
- Consider obtaining equity compensation plan approval a year before you need it.
- When proposing to amend an equity compensation plan, consider describing the methodology used to determine the requested number of additional shares, dilutive impact and expected and/or historical usage rates, as well as the number of shares available under the plan as of a recent date (especially if the company has just made its annual equity compensation grants). The relatively boilerplate disclosure of years past may not be sufficient to withstand a claim.
- The description of a Section 162(m) plan in the annual proxy statement should accurately reflect its operation in practice, and companies should take steps to ensure that those responsible for implementing Section 162(m) plans operate such plans in accordance with their terms.
- Even if a plan is designed to comply with Section 162(m), avoid making statements in an annual proxy statement that could be interpreted to guarantee that payments under the plan will be tax-deductible in all circumstances.
- Consider whether incentive compensation plans for directors should be separate from those for executives, in order to reduce the likelihood of a finding of director interestedness or non-independence.
- Avoid being an outlier—minimize the risk of becoming a target by making sure you know what your peers are doing and ensuring that your compensation and disclosure practices are in line with customary industry standards.

(cont.)

compensation committee pursuant to the terms of an “inner” plan. This structure is common among performance-based plans designed to comply with Section 162(m).

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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