

Is Proxy Disclosure Shareholder Litigation on Executive Compensation Finally Over?

By Sarah A. Good, Cindy V. Schlaefer, Laura C. Hurtado and Dorothy Kaslow

Since the advent of “Say-on-Pay” over three years ago, the plaintiffs’ securities bar has attempted to rustle up claims relating to executive compensation matters discussed in proxy statements. The first wave against those companies with failed “say-on-pay” votes that nonetheless approved the compensation quickly sprang up and then ended. The second wave sought to enjoin annual meetings due to the purported inadequacy of disclosures in proxy statements; it largely failed despite two early successes. Undeterred, plaintiffs’ lawyers filed a third wave of shareholder litigation alleging that companies granted compensation in excess of applicable stock plan limits which was not tax-deductible under Internal Revenue Code Section 162(m) despite affirmations to the contrary in proxy statements. While the third wave continues, it too is stalling.

The height of the proxy season has passed, and so it is time to check the pulse of shareholder litigation concerning executive compensation matters. Our prior client alerts in [November 2012](#) and [February 2013](#) outlined the three waves of shareholder litigation concerning executive compensation. The first two waves have died while the third wave is waning. Below and in the attached Appendices, we update our metrics on the three waves of shareholder litigation. In addition, we offer tips to issuers to avoid being targeted in the third wave.

First and Second Waves

The first wave of shareholder litigation filed against companies approving executive compensation proposals that failed say-on-pay votes has long been over. No new cases have been filed since September 2012. Courts granted 50 percent of motions to dismiss those complaints, which targeted 21 public companies.

With the demise of the first wave, plaintiffs busily filed new cases in the second wave that sought to enjoin annual meetings by contending that the disclosures concerning executive compensation proposals were inadequate. Those cases shared many characteristics of shareholder litigation concerning mergers and acquisitions which are filed in connection with over 90 percent of all such transactions. In those cases, plaintiffs may hope that defendants who have worked long and hard on those transactions and believe them to be in the best interests of shareholders will settle for additional disclosure and a cash payment of substantial attorney's fees with minimal work on the part of plaintiffs' counsel. Since last year, plaintiffs have learned, that while many companies in mergers and acquisitions succumb to the pressure inflicted by plaintiffs in holding up consummation of their deals and settle, companies faced with delaying votes on proposals concerning executive compensation or increasing the shares available under stock plans often fight rather than settle. And, when those companies fight, they win.

Notably, plaintiffs have prevailed on motions to preliminarily enjoin the annual meeting, either in whole or in part, on only two occasions: (a) in April 2012 against Brocade and (b) in October 2012 against Abaxis. In contrast, the same motion has been denied against 13 issuers by a multitude of courts. Not surprisingly, the pace of new case filings has abated with only two new cases filed, one in December 2013 and the other in January 2014. In those cases against Star Scientific Inc. and Avanir Pharmaceutical Inc., the courts denied the motion for preliminary injunction and plaintiffs voluntarily dismissed the cases with no recovery. Overall, in cases against 31 issuers, nearly 40 percent have resulted in the denial of a motion to enjoin the annual meeting and over 25 percent have been voluntarily dismissed for no consideration, often before any motion practice at all.

Since December 2013, a plaintiff's law firm has continued to issue press releases "investigating" companies in connection with their proxy statement disclosures concerning executive compensation. However, other than the two new cases filed, none of those press releases has resulted in actual litigation. It is possible that companies are resolving disputes with plaintiffs' firms in out-of-court settlements that are not binding on other shareholders. However, the commanding statistics favoring defendants on motions and voluntarily dismissals should persuade companies to stand firm and refuse to settle.

Third Wave

With the second wave ending, plaintiffs are still filing suits concerning executive compensation issues in the third wave, which has targeted 29 issuers. In 2013, 14 issuers were targeted, and two have been the subject of a suit in 2014. The companies run the gamut of industries and range from NYSE companies with a market capitalization of over \$50 billion to smaller NASDAQ companies with a market capitalization of under \$500 million. So the size of the issuer involved and its business are not indicators in predicting whether or not a company may become the subject of such a suit. Instead, plaintiffs' law firms are scrutinizing proxy statements and awards to find potential instances in which a company's awards appear not to have complied with the letter of the relevant plan. These suits often are derivative shareholder suits or a hybrid of a derivative shareholder suit and a class action. The key allegations fall within three categories:

1. The board of directors granted awards under a stock incentive plan in an amount that exceeded the maximum annual limit imposed by the plan although the proxy statement represented that all awards were made in conformity with the plan.
2. The board of directors granted awards under a stock incentive plan that had lapsed due to the board's failure to seek stockholder re-approval of the plan every five years to preserve the tax

deductibility of awards under Internal Revenue Code Section 162(m), although the proxy statement represented that all awards were made in conformity with the plan.

3. The board of directors granted awards under a stock incentive plan that were not tax deductible under Internal Revenue Code Section 162(m) although the proxy statement represented that all awards would be tax deductible.

In a number of instances, companies have been successful on motions to dismiss primarily on the basis of a procedural argument that plaintiffs have failed to adequately plead an excuse for their failure to first make a demand on the Board prior to filing a derivative suit. In particular, motions to dismiss have been granted in 20 percent of the cases and denied in 9 percent although such motions remain pending in 20 percent. The actions have settled in 24 percent of the cases and another 6 percent have involved a stipulation among the parties that plaintiff's claims are moot because the company took the corrective action requested in the complaints. More than half of these cases have been filed in the U.S. District Court for the District of Delaware.

In the resolution of securities fraud class actions and shareholder litigation, the parties nearly always reach agreement on the substantive contours of a settlement and then proceed to separately discuss and reach agreement on the amount of attorney's fees to be awarded subject to the court's approval. In that fashion, the parties do not continue to incur fees and costs in additional litigation and have certainty over the size of the settlement.

Surprisingly, in these suits concerning executive compensation, the settling parties often have left the amount of attorney's fees to be awarded open to further litigation. In a recent case in the U.S. District Court for the District of Delaware, plaintiff's counsel sought an award of approximately \$1,050,000 while defendants asserted that \$150,000 was appropriate. There, the court awarded plaintiff's counsel \$200,000 in fees. There are two other third wave cases pending in the same court in which the parties are disputing the amount of attorney's fees – in one case, plaintiff's counsel is seeking approximately \$836,000 and in another \$1,990,000. If the earlier ruling is any indication, plaintiff's counsel likely will have an uphill battle persuading the courts in those cases to grant attorney's fees at anywhere near the requested amounts. In another case in the U.S. District Court for the District of Montana, now on appeal, the court considered plaintiff's request for approximately \$976,000 in attorney's fees and awarded \$0 on the derivative claims. All of these decisions may give plaintiffs' counsel pause in considering whether or not to file new third wave cases in the future.

Prevention Tips

In any event, these suits are preventable. Issuers, their boards of directors, compensation committees and in-house counsel can take the following steps to ensure that the company is not targeted in this third wave of shareholder litigation:

- Evaluate every grant to make sure that it does not run afoul of the operative stock incentive plan in any respect. In particular, ensure that no award exceeds the maximum annual or other periodic limit imposed by the plan. *If a problem is found, correct it immediately in consultation with in-house and/or outside counsel before any shareholder litigation is filed or a shareholder demand is received.*
- Be careful to seek re-approval of the plan every five years to the extent required to preserve the tax deductibility of performance-based awards under Internal Revenue Code Section 162(m). Impose a system of controls that ensures that this deadline does not fall between the cracks.

- Ensure that the language in the plan as well as the proxy statement does not guarantee that every award will be exempt from the tax deduction limits under Internal Revenue Code Section 162(m). Language that the company *may* make awards that are exempt under Section 162(m) provides the company and its compensation committee with greater flexibility.

If companies take the steps outlined above, they should avoid being targeted in the third wave of shareholder litigation concerning executive compensation – and bring this final wave, which is sputtering out, to an end.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

Sarah A. Good **(bio)**
San Francisco
+1.415.983.1314
sarah.good@pillsburylaw.com

Cindy V. Schlaefer **(bio)**
Silicon Valley
+1.650.233.4023
cindy.schlaefer@pillsburylaw.com

Laura C. Hurtado **(bio)**
San Francisco
+1.415.983.1082
laura.hurtado@pillsburylaw.com

Dorothy Kaslow **(bio)**
San Francisco
+1.415.983.7315
dorothy.kaslow@pillsburylaw.com

**APPENDIX OF FIRST WAVE CASES:
Say-on-Pay Derivative Shareholder Suits against 21 Companies**

Disposition of Cases	No. of Cases	Percentage
Settled <ul style="list-style-type: none"> ▪ After Motion to Dismiss Denied: 1 Case ▪ With No Ruling on Motion to Dismiss: 4 Cases 	5	21%
Motion to Dismiss Granted <ul style="list-style-type: none"> ▪ Final: 11 Cases ▪ Affirmed on Appeal and Now Final: 1 Case 	12	50%
Motion to Dismiss Pending	4	17%
Defendant's Motion for Summary Judgment granted and currently on appeal	1	4%
Voluntary Dismissal	2	8%
Total	24	100%
Jurisdiction ¹	No. of Cases	
U.S. District Court – N.D. California	2	
U.S. District Court – S.D. California (two state court cases removed and consolidated, then remanded to California Superior Court – San Diego County)	1	
U.S. District Court – Colorado (2 cases consolidated)	1	
U.S. District Court – Delaware	3	
U.S. District Court – N.D. Illinois	1	
U.S. District Court – Maryland	1	
U.S. District Court – New Jersey	1	
U.S. District Court – S.D. New York (3 cases consolidated)	1	
U.S. District Court – E.D. North Carolina	1	
U.S. District Court – N.D. Ohio (4 cases – 3 of which were consolidated)	2	
U.S. District Court – S.D. Ohio	1	
U.S. District Court – Oregon	1	
U.S. District Court – S.D. Texas	3	
California Superior Court – Los Angeles County	2	
Delaware Court of Chancery (2 cases consolidated)	1	
Georgia Superior Court – Fulton County	1	
Texas State Court – Harris County	2	



¹ In numerous circumstances, different plaintiffs filed suits in multiple courts. Consolidated cases are listed as a single case. Cases not subsequently consolidated are counted separately.

**APPENDIX OF SECOND WAVE CASES:
Putative Class Actions Seeking Injunctive Relief against 31 Companies**

Disposition	No. of Cases	Percentage
Plaintiffs' motion for preliminary injunction granted and then subsequently settled	2	6%
Plaintiffs' motion for preliminary injunction denied <ul style="list-style-type: none"> ▪ Subsequently dismissed voluntarily by plaintiffs: 8 Cases ▪ Subsequently had defendants' motions to dismiss granted: 3 Cases ▪ Defendants' motion for summary judgment granted and final judgment entered: 1 Case 	12	39%
Settled <ul style="list-style-type: none"> ▪ 6 cases prior to ruling on plaintiffs' motion for preliminary injunction ▪ 1 case without any motion for preliminary injunction having been filed ▪ 1 case after motion to dismiss granted 	8	26%
Plaintiff voluntarily dismissed case without settlement (excluding 8 cases voluntarily dismissed after denial of motion for preliminary injunction)	8	26%
Motion to dismiss granted ²	1	3%
Total	31	100%
Jurisdiction	No. of Cases	
Arizona Superior Court – Maricopa County	1	
California Superior Court – Alameda County	1	
California Superior Court – Los Angeles County	1	
California Superior Court – San Diego County	1	
California Superior Court – Santa Clara County (one of which was remanded back from U.S. District Court – N.D. Cal.)	4	
California Superior Court – Santa Cruz County	1	
U.S. District Court - Delaware	2	
Circuit Court of Missouri – Jackson County	1	
Supreme Court of New York – County of New York	5	
Supreme Court of New York – County of Suffolk	1	
Supreme Court of New York – County of Albany	1	
Supreme Court of New York – County of Nassau	1	
District Court of Texas, Travis County	1	
Tennessee Chancery Court – County of Shelby	1	
Washington Superior Court – King County	1	
U.S. District Court – N.D. California (one after removal from California Superior Court – County of Santa Clara)	2	
U.S. District Court – C.D. California	1	
U.S. District Court – N.D. Illinois (after removal from Illinois state court)	1	
U.S. District Court – District of New Jersey	1	
U.S. District Court – S.D. New York (one case removed from New York Supreme Court)	2	
U.S. District Court – District of Utah	1	

² Granted by Magistrate Judge; Plaintiffs have yet to file their objections to the Report & Recommendation.

**APPENDIX OF THIRD WAVE CASES:
Recent Derivative Shareholder Suits against 29 Companies**

Disposition	No. of Cases	Percentage
Summary Judgment Pending	1	3%
Pending	1	3%
Motion to Dismiss Pending	7	20%
Motion to Dismiss Granted <ul style="list-style-type: none"> ▪ Final: 5³ Cases ▪ On Appeal: 2 Cases 	7	20%
Motion to Dismiss Denied	3	9%
Demurrer granted without leave to amend all but one cause of action; appeal and motion to stay pending	1	3%
Settled	8	24%
Stipulation Filed that Plaintiff's Claims Are Moot and Motion for Attorney's Fees Is Pending	2	6%
Voluntary Dismissal/Stipulation to Dismissal <ul style="list-style-type: none"> ▪ Voluntary Dismissal: 3 Cases ▪ Motion to Dismiss granted in part and Stipulation to Dismissal: 1 Case 	4	12%
Total	34	100%
Jurisdiction	No. of Cases	
California Superior Court, County of Orange	1	
Delaware Court of Chancery (two cases against one company, subsequently consolidated)	4	
Illinois Circuit Court, DuPage County	1	
District Court, Clark County, Nevada	1	
Supreme Court of New York – County of New York	1	
Tennessee State Court, Knox County	1	
U.S. District Court – C.D. California (two cases against one company, subsequently consolidated)	1	
U.S. District Court – Delaware (four cases were against two companies, subsequently consolidated into one case against each company)	16	
U.S. District Court – N.D. Illinois	2	
U.S. District Court – Montana	1	
U.S. District Court – Nevada (two cases against one company, subsequently consolidated)	1	
U.S. District Court – E.D. Pennsylvania	1	
U.S. District Court – Utah	1	
U.S. District Court – Ohio	1	
U.S. District Court – New Jersey	1	

³ For one such case, Motion to Dismiss granted by Magistrate Judge; Plaintiffs have yet to file their objections to the Report & Recommendation.

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