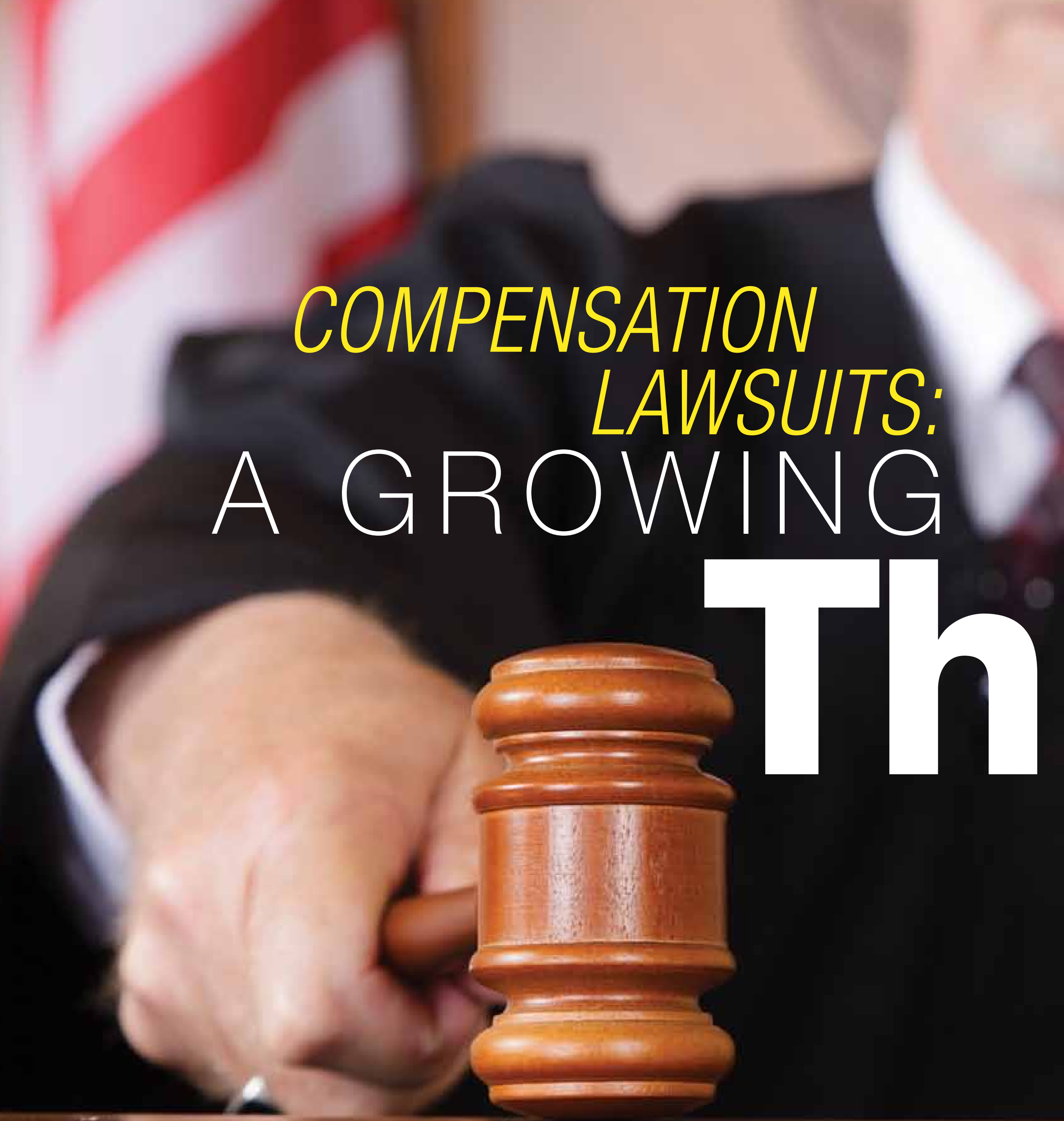
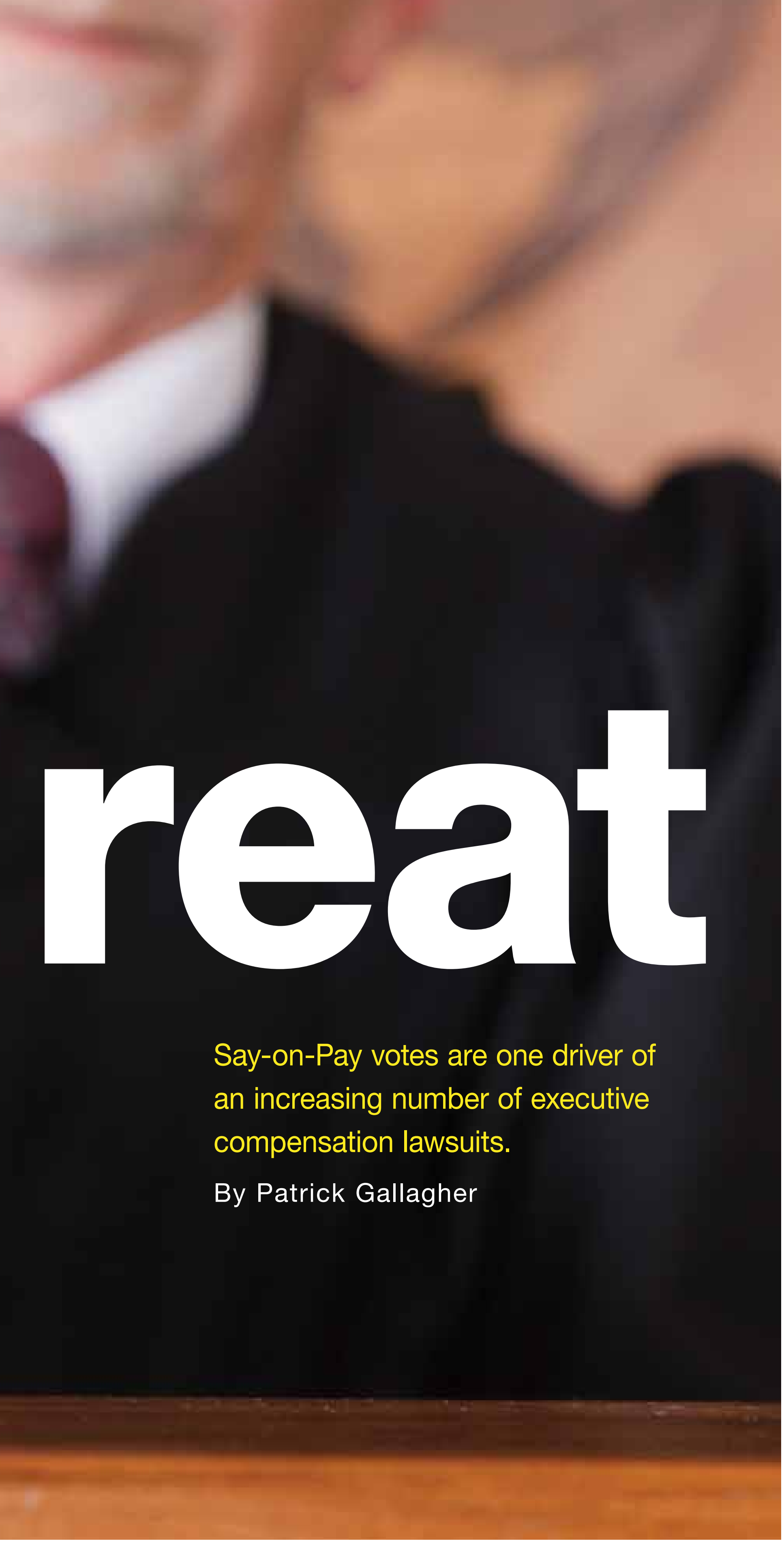
COMPENSATION LAWSUITS: A GROWING Th





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Say-on-Pay votes are one driver of an increasing number of executive compensation lawsuits.

By Patrick Gallagher

Investor relations officers know that dealing with securities lawsuits is an inevitable cost of doing business as a public company. Earnings restatement? Expect lawsuits. Sharp drop in the stock price after an adverse earnings report? Expect lawsuits. Announce a merger or acquisition? Expect lawsuits. But propose a new executive compensation plan in your proxy statement and get sued? Don't be surprised.

Various plaintiff law firms, most notably Faruqi & Faruqi, issued more than 30 notices of investigation related to executive compensation during 2012 and filed suit against more than 20 companies, including Microsoft, Cisco, and Clorox.

These executive compensation suits represent "a new growth area for the plaintiff bar," says Robert Daines, a professor of law and business at Stanford Law School, who recently co-authored a major study on litigation challenging merger-and-acquisition deals.

Say-on-Pay Opens Door

The initial flurry of new executive compensation-related lawsuits appeared in the 2011 proxy season as a result of the shareholder "Say-on-Pay" vote mandated by the Dodd-Frank Act. The boards of companies that failed to receive majority shareholder support were sued for breach of fiduciary duty for being unresponsive to their shareholders.

Courts have dismissed most of these cases early in the proceedings because the plaintiff failed to allege facts in addition to a failed shareholder Say-on-Pay vote sufficient to rebut the business judgment rule presumption afforded to a board's decisions or failed to make demands on the companies before bringing suit, as required in shareholder derivative actions, says David Zagore, a partner with Squire Sanders. (In a derivative action, shareholders bring suit against the directors and/or officers on behalf of the corporation.)

These suits had another defect: Dodd-Frank states very clearly that a negative Say-on-Pay vote is not binding on the company and does not create or imply any change to the board's fiduciary duties. So it was perhaps not surprising when plaintiff's bar introduced a new strategy during the 2012 proxy season.

YOU ARE UNDER INVESTIGATION

A merger-objection or executive-compensation disclosure lawsuit often begins with a news release from a law firm announcing it is investigating a company's board of directors for potential breaches of fiduciary duties.

As some companies have found, just this announcement can be problematic – even if a lawsuit never follows. Employees, customers, small shareholders, and others are not aware that dozens of identical "investigations" are announced every week during proxy season based on nothing more than the announcement of a merger-and-acquisition transaction or the filing of a proxy statement that includes an executive compensation proposal. These stakeholders just see the report about your company.

One firm that was the target of such an investigation learned that managers at a major customer were alarmed to learn of the news and unhappy that the company had not advised them about what they presumed was a serious corporate matter. One of the managers asked in an e-mail that was forwarded to the company if they should be looking for another supplier.

On the chance this was not an isolated event, the company decided to distribute the standby statement and Q&A it had prepared to all employees with a message from the CEO and encouraged sales and customer service people to be on the alert for possible customer concerns.

Source of Leverage

The new strategy evolved from lucrative merger-objection lawsuits, where timely filing gives the plaintiffs leverage by threatening to delay or even derail an acquisition, says Christina Costley, an attorney with Katten Muchin Rosenman.

Similarly, when companies are targeted with one of these executive compensation disclosure suits, they need to consider whether defending the lawsuit might mean postponing the annual meeting, potentially disrupting business to be transacted. For many companies in this position, settlement is the path of least resistance, says David Priebe, a partner at DLA Piper.

The plaintiff bar's new approach does not focus *per se* on the Say-on-Pay vote or the company's proposed compensation or stock plan, but rather alleges breach of fiduciary duty due to insufficient disclosure. The complaints often cite dilutive increases in the number of shares available under a proposed equity incentive plan. Some cases have asserted the need for additional detail regarding the peer group selection and the recommendations of outside compensation consultants.

Pressure to Settle

One of the first of these suits to come before a court was filed by Faruqi & Faruqi in the Superior Court of California in Santa Clara County in March 2012 against Brocade Communications. The suit alleged insufficient disclosure regarding a proposed increase to the number of authorized shares available for grant under Brocade's equity incentive program.

On April 10, just two days before Brocade's scheduled shareholders meeting, the judge issued a preliminary injunction, saying he thought it was reasonable for shareholders to see the same information the board of directors had, says Priebe. The next day Brocade announced a settlement under which it disclosed its internal projections regarding future stock grants and agreed to reimburse the law firm up to $625,000 in attorney fees. During the next few months, three other companies settled similar cases by agreeing to additional disclosures and paying attorney fees, according to Costley.

As Daines points out, in both the merger-objection suits and the newer executive compensation cases, the plaintiff firms typically aren't looking to litigate for a big payment. Their objective is a quick settlement for additional disclosure and reimbursement of attorney fees.

The rationale for these claims is troubling, observes Priebe. "None of these complaints have alleged any misstatements, just insufficient information. It is a slippery slope. Regardless of how much information a company may disclose, a plaintiff may assert that even more is required. And paradoxically, a company that chooses to disclose more rather than less may find that this only prompts further requests for even more detail."

Priebe also questions the need for an injunction in these cases. "If shareholders believe there is insufficient information, they can simply vote against the proposal or abstain, which counts as a 'No' vote. This is a self-correcting problem."

Brocade an Anomaly?

The Brocade case was a wake-up call, but it is beginning to look like it may be an anomaly. Several attorneys point to the Symantec case, filed by the same plaintiff firm in the same Santa Clara Superior Court in September 2012. In October the court denied plaintiff's attempt to delay the Say-on-Pay vote due to inadequate disclosures, finding no precedent for such an injunction. Tellingly, several attorneys point out, the court heard an expert opinion from Daines, who concluded based on his survey that

Symantec's disclosures were in line with Dodd-Frank and at least as detailed as those made by other companies in its industry.

Defendants have also fended off the plaintiffs in three other compensation disclosure cases that went before a judge in 2012.

In a case filed in January 2012 against Amdocs Limited, plaintiff claimed inadequate disclosure related to an increase in the number of shares available under an equity incentive plan. After the defendants had the case removed from state to federal court and opposed plaintiff's request for a preliminary injunction, plaintiff voluntarily dismissed the claim.

In October, defendant AAR Corporation prevailed in a suit filed just four business days ahead of the company's scheduled annual meeting. The plaintiff sought to enjoin the Say-on-Pay vote alleging that the proxy statement omitted material information regarding peer companies and fees paid to a compensation consultant. The case was removed to federal court, and at a hearing, the judge denied plaintiff's motion for a temporary restraining order, according to Costley, whose firm represented AAR.

Most recently, the plaintiff in the claim filed against Microsoft in October withdrew the suit several weeks ahead of the company's November 28, 2012 annual meeting.

Looking Ahead

Most of the experts we spoke with expect these compensation disclosure investigations and lawsuits will continue in the 2013 proxy season, but they regard the trend in these recent cases as favorable to corporations.

Zagore of Squire Sanders says it has become a lot more difficult for plaintiffs to survive a motion to dismiss in these Say-on-Pay and executive-compensation disclosure suits, as compared with the merger-objection suits.

"The sale of a company has always been one of those major events where courts view it as fair for shareholders to ask the board to explain the basis for its decision," he says. "Now we are seeing many more breach of fiduciary duty suits involving day-to-day events. Courts have commonly found that executive compensation decisions made by independent directors fall within the protections afforded by the business judgment rule. Compensation is inherently business judgment."

Priebe believes that these recent dismissals and withdrawals may have sealed the deal. But if not, he says, once a case gets to Delaware it will become clear whether these theories have validity and what information companies need to include in their disclosure. It would shorten the process if one of these cases came before the court in Delaware, but as far as he knows, that has not happened. The plaintiff law firms appear to have purposely avoided Delaware, even though more than half of all public companies are incorporated there. IRU

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THE TRIAL LAWYERS' MERGER TAX

Litigation involving mergers and acquisitions of U.S. public companies is keeping a whole lot of courts and attorneys busy. According to a 2012 study conducted by Stanford Law Professor Robert Daines and the commercial litigation consulting firm Cornerstone Research, 91 percent of acquisitions of U.S. public companies valued at more than $100 million in 2010 and 2011 elicited multiple lawsuits, usually in multiple jurisdictions. That was up dramatically from just about half of such transactions in 2007.

According to the insurance analytics firm Advisen, these merger-objection lawsuits rarely block the deals or result in meaningful payouts to the shareholders. The suits are often settled before a deal's closing in exchange for a few extra disclosures in deal documents and reimbursement of plaintiff's attorneys fees plus, on occasion, a cash settlement. The attorney fees range from roughly $400,000-$500,000 for typical cases up to several million dollars for bigger cases. The U.S. Chamber of Commerce has dubbed these settlements "the trial lawyers' merger tax."

One company has said enough is enough. According to a recent Thomson Reuters news report, after Intel announced its $7.68 billion acquisition of McAfee in 2010, the inevitable shareholder suits followed. Yet there was no quick settlement. Instead, the boards of the two companies elected to litigate. And they won. A state court judge in California tossed the shareholders' class action this past November, more than a year after the deal closed and more than two years after the litigation began.

"Intel decided it didn't want to pay extortion every time it acquired a company," Intel counsel Wayne Smith of Gibson, Dunn & Crutcher told Thomson Reuters.

Despite Intel's stand, the trial lawyers' fees and rising defense costs in these merger-objection cases are getting the attention of D&O insurers, says Kevin LaCroix, executive vice president of OakBridge Insurance Services, a division of RTS Specialty, and author of the D&O Diary Blog.

"We are seeing upward pressure on rates as underwriters take into account the loss costs they are incurring in this category due to the accumulation of smaller losses," he says.