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Plaintiffs Lawyers Target Delaware Corporations on 'Say-on-Pay' Disclosures

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Delaware corporations by now are well aware that virtually all material corporate transactions attract shareholder litigation of one form or another. This proxy season, there has been a surge of cases against Delaware corporations asserting shareholder derivative claims in connection with "say-on-pay" proxy disclosures and approval of equity incentive plans.

Say-On-Pay Rules in Dodd-Frank

The Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in 2010 and was intended to "improv[e] accountability and transparency in the financial system." Section 951 and its implementing regulations mandate that at least once every three years public companies hold a non-binding, advisory vote on executive compensation. After the filing of proxy statements, and in advance of annual meetings and scheduled proxy voting, plaintiffs counsel have begun filing complaints asking courts to enjoin annual shareholder votes based on purported disclosure deficiencies in proxy statements related to say-on-pay requirements. Dodd-Frank expressly states that it does not impose new fiduciary duties on Delaware corporations or their boards.

Plaintiffs' 'End Run' Around Dodd-Frank

Despite the fact that Dodd-Frank did not create new Delaware disclosure duties, plaintiffs lawyers have asked courts to extend state-law-based fiduciary duties to include additional say-on-pay disclosure requirements. Within the last year, at least 20 issuers have been sued in cases alleging that their executive compensation disclosures are insufficient under state law. These suits have been filed in multiple forums, including California, New York, Washington and Illinois. Importantly, none of the say-on-pay cases filed against Delaware corporations actually have been filed in Delaware Chancery Court, the one court that is well-versed in litigating claims related to breaches of the "duty of candor." Moreover, plaintiffs firms have announced "investigations" of more than 50 other issuers — including 20 since the beginning of 2013 — no doubt designed to attract shareholders willing to serve as representative plaintiffs in such lawsuits.

Say-on-Pay Claims

Common allegations in the say-on-pay cases involve disclosures relating to compensation consultants' reports, the issuers' analyses of compensation benchmarks, comparisons of specific elements of compensation plans with industry peers, and the rationale for executive severance agreements. These complaints generally allege that the proxy statement fails to disclose: how the compensation committee selected the compensation consultant and the amount of fees paid to the compensation consultant; a fair summary of the advice, counsel and analyses performed and provided by the compensation consultant; compensation data for the named executive officers of peer companies; total direct compensation data for each of the peer companies; and how much weight the compensation committee accorded to each of the listed factors.

The lead case on which much attention has been focused is *Knee v. Brocade Communications Systems*, No. 1-12-CV-220249 (Cal. Sup. Ct. Santa Clara, April 10, 2012), in which shareholders sought to enjoin Brocade's scheduled annual shareholder vote. The court granted the plaintiffs' motion for a preliminary injunction, finding that the plaintiffs had shown a likelihood of success on the claim that Brocade's allegedly inadequate proxy disclosures amounted to a breach of fiduciary duty. Countering the plaintiffs' win in Brocade, however, courts in New York and California have denied similar plaintiffs' motions for injunctive relief in cases against Symantec, Clorox and Globecomm Systems.

Claims Related to Equity Incentive Plans

Plaintiffs firms also have sued over disclosures relating to equity incentive plans. These complaints generally allege that the proxy fails to disclose: a fair summary of any expert's analysis or any opinion obtained in connection with the equity incentive plan; the criteria used by the compensation committee to implement the stock purchase plan; the dilutive impact that issuing additional shares may have on existing shareholders; and how the board determined the number of additional shares requested to be authorized.

Defense Strategies

In two of the cases brought so far, companies defeated motions to preliminarily enjoin their annual shareholder meetings by presenting expert testimony showing that the disclosures at issue were consistent with "best practices" disclosures of peer companies in the same industry. In another case, the company received support from a large shareholder, who told the court that the company's proxy statement adequately disclosed all material facts that the shareholder needed to cast an informed vote.

In defending these suits, Delaware corporations also should explain overall disclosure regime, including the "total mix" standard of materiality that applies in federal securities cases, and those relating to proxy claims under Section 14 of the Securities Exchange Act of 1934. Because the "total mix" standard is widely accepted, but not typically subject to quantifiable measures, much of the litigation risk associated with proxy disclosure litigation arises from state courts' general unwillingness to apply the materiality concept to dismiss cases early in the litigation process.

Mitigating Litigation Risks

There are a few steps companies can take to mitigate litigation risks. First, companies should review their proxy disclosures on both say-on-pay and equity incentive plan issues to disclosures provided by peer companies and best practices within the same industry. Second, companies should consider whether to include more detailed disclosures relating to peer group analyses and how specific elements of the executives' compensation fit within the stated philosophy. Third, companies seeking shareholder approval of equity incentive plans or increases to the number of shares that may be issued under existing equity incentive plans should consider disclosing the dilutive effects of such plans, even if considered immaterial by most objective standards.

Concluding Thoughts

The plaintiffs bar is demonstrating both ingenuity and opportunism in expanding proxy litigation claims from the familiar M&A context to say-on-pay and other issues. Although no disclosure can completely insulate issuers from the risk associated with such claims, companies can reduce the litigation risk by reviewing their disclosures carefully and comparing them to the types of information provided by peer companies and based on "best practices"; creating a documented record of boards, board committees and consultants' analyses and processes; and preparing in advance to defend disclosure claims on an expedited basis in the context of a request for preliminary injunctive or other emergency relief.

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