December 5, 2012

Proxy Statement Attacks Continue

In September, we advised about a new wave of executive compensation investigations by the plaintiffs' bar. The investigations (primarily issued by plaintiffs' firm Faruqi & Faruqi) dealt with (1) advisory votes on executive compensation required by the Dodd-Frank Act's say-on-pay provision, and (2) votes to authorize or issue additional shares of stock, both in connection with executive compensation plans and with total authorized shares. The investigations resulted in 19 lawsuits, 3 of which were defended by Katten's Securities Litigation Practice.

In November, the plaintiffs' bar shifted its focus to stock issuance. We have continued to see investigation notices from Faruqi & Faruqi and, in the past two weeks, we have also seen a flurry of investigation notices from another plaintiffs' firm, Levi & Korsinsky. The investigation notices, though brief and vaguely worded, appear to be seeking stockholders to sue in the following circumstances:

Pending Share Authorization. Plaintiffs' firms have noticed investigations after the target companies file proxy statements in connection with upcoming annual meetings or special votes to amend the articles of incorporation or to authorize additional shares of common stock. These investigations are being noticed before the stockholder meeting, so we believe the cases will be brought on an emergency basis to enjoin the meeting and require additional disclosures. Katten defended two of these cases, *Amdocs* and *Applied Minerals*, and obtained dismissals in both before the preliminary injunction hearing. Two other cases in California state court had mixed results, with the Santa Clara County Superior Court denying the motion for a preliminary injunction in *Ultratech* but enjoining the shareholder vote and requiring further disclosure in *Brocade*.

Too Many Shares Granted. Plaintiffs' firms have noticed investigations, or brought lawsuits, when target companies have granted more shares to executives and/or directors than authorized by the companies' incentive plans. These investigations are being noticed after the annual meeting occurs, normally following a Form 8-K announcing the retention of a new executive (who receives stock in connection with his employment agreement) or a change to the compensation agreements with existing officers and directors. We have also seen investigation notices after a company announces in an 8-K that it has granted a new hire more shares than corporate governance documents or incentive plans permit a single executive to receive in a single year. The lawsuits resulting from these investigations have been brought as derivative claims for self-dealing, waste, and dilution. In some instances, they have also been brought as disclosure claims under Section 14(a) of the Securities Exchange Act of 1934 or Delaware law. Though it is too early to tell how these cases will be resolved (we believe that, as derivative claims, they should be defensible at the pleading stage), plaintiffs have had at least one early success. In *Abaxis*, the plaintiff obtained an injunction requiring further disclosures in an amended proxy statement regarding the company's grants in excess of the authorized amount. Though the information the plaintiff argued should have been disclosed had already been disclosed by the company in a Form 8-K, the proxy statement did not incorporate the 8-K by reference and, as a result, the court found a disclosure violation.

If you have any questions or would like to discuss your own proxy, an announced investigation or a lawsuit, please contact any of the following members of Katten's **Securities Litigation and Enforcement Practice**.

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Too Few Shares Held. Plaintiffs' firms have noticed investigations where executives of the target companies have sold shares and no longer hold the minimum number of shares required by the company's corporate governance policies. These investigations appear to be precipitated by the filing of a Form 4 announcing the sale of stock by a company executive. We have not seen any lawsuits on this basis yet, but believe that, if these investigations result in lawsuits, they likely will be filed derivatively, for breach of the duty of good faith, and also potentially as Section 14(a) claims or claims for violation of the duty of disclosure.

Exempt Offering to Executives. We have not seen complaints filed on this basis, but we have seen notices following the announcement of an offering. If the investigations result in lawsuits, we anticipate they will be brought as derivative claims alleging that the offering constitutes additional compensation that should have been voted on by stockholders (or that should be treated as issued under the equity incentive plan), and that the board, by failing to hold such a vote, violated its duty of disclosure or good faith.

IRC Section 162(m). A handful of lawsuits have been brought on a theory that the defendant corporation failed to obtain stockholder authorization of performance goals under IRC Section 162(m), or failed to require compliance with those performance goals prior to issuing executive compensation. Plaintiffs then allege that, by not being able to claim the IRC 162(m) tax deduction, the board has committed waste. This is an old theory, first raised in the 1990s without much success, but it appears to be experiencing a revival. The District Court of Delaware, applying Delaware law, held that plaintiffs had adequately pled demand futility and denied defendants' motion to dismiss in two of these cases, *Archer-Daniels-Midland* (D. Del. March 28, 2011) and *Qualcomm* (D. Del. July 1, 2011). The Delaware Court of Chancery, however, more recently found that demand futility had not been pled in *XTO Energy* (Del. Ct. Ch. Mar. 30, 2012). Likely as a result of these cases, plaintiffs are continuing to file 162(m) lawsuits in the District Court of Delaware and other federal courts; whether they will succeed remains an open question.

In view of the new focus on executive compensation reflected in the Dodd-Frank Act and the drive to link executive compensation directly to stock performance, we expect to see investigations and lawsuits related to equity compensation gain steam throughout 2013, particularly as proxy season gets under way. Of course, lawsuits based on equity granting practices are nothing new; but the new governance standards that require even larger quantities of equity for use in compensation plans and (arguably) greater disclosures related to executive compensation appear to be giving rise to a new wave of litigation from which no public company is safe. We will continue to keep you updated as these lawsuits take shape.

12/4/12