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

By Patrick Gallagher


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

By Patrick Gallagher
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.

Source of Leverage
The new strategy evolved from lucrative merger-objectection 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 Pribe, 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 Pribe. 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-objectection 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 Pribe. “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.”

Pribe 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.

Patrick Gallagher is a senior counsel with Fahlgren Mortine; pat.gallagher@fahlgren.com.