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Corporate Governance Update

Be Prepared for the New Wave of Proxy Disclosure Litigation

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The say-on-pay advisory vote requirements of the Dodd-Frank Act of 2010[1] have turned out to be a fertile source of nuisance litigation filed by aggressive plaintiffs' lawyers. The first wave of lawsuits generally consisted of after-the-fact actions targeting companies that experienced failed say-on-pay advisory votes. These initial cases, which appeared primarily to be attempts to extort settlements, were nearly all dismissed on procedural grounds.[2] The current wave, embodied by a recent spate of lawsuits filed primarily by a single plaintiffs' law firm, is potentially more problematic from a practical perspective for targeted companies, even though the claims involved appear to have even less basis in law or fact. The pattern of these recent actions is for a lawsuit to be filed in state court sometime between the filing of the definitive proxy statement and the date of the annual meeting, alleging that the proxy disclosure is inadequate with respect to executive compensation (or relating to the authorization or issuance of additional common shares for equity incentive plans), claiming breach of fiduciary duty by directors, and calling for the shareholder meeting to be enjoined until additional disclosure is made.

Directors and corporate managers need to be prepared for this type of proxy disclosure litigation, particularly since it appears that little can be done to prevent such lawsuits from being brought. Boards of companies that are targeted in this manner may feel significant pressure to settle because they do not want to postpone the annual meeting or, worse, face the possibility that the required say-on-pay advisory vote or other needed votes could be enjoined.[3] However, it is worth noting that the earlier wave of lawsuits that targeted companies with failed say-on-pay votes has subsided, undoubtedly due to the discouraging results obtained by the plaintiffs in court. The same fate is likely to befall the current wave, but only if companies are willing to fight these lawsuits in court so that the plaintiffs and their attorneys encounter judicial skepticism and dismissal rather than the rewards of a quick and lucrative settlement.

As the 2013 proxy season approaches, companies should advise their boards to be aware of this potential litigation threat. It may be helpful for boards to discuss the 2012 cases with their internal counsel, review the attendant settlements or adjudications, request that outside securities and litigation counsel review the draft proxy statement, and generally prepare for the possibility of facing such litigation under the time pressure of an approaching annual meeting.

Proxy Litigation Landscape

The new wave of proxy disclosure litigation is similar to a well-known type of lawsuit in the mergers-and-acquisitions context. Class actions are frequently filed against companies that have announced a merger transaction,[4] with the plaintiffs and their attorneys seeking to enjoin the shareholder vote on the basis that the publicly-filed documents for the transaction contain inadequate disclosure; these litigants effectively threaten to delay the transaction unless the case can be resolved by judicial means or through a settlement.

Proxy disclosure lawsuits in the annual meeting context gathered momentum after an early victory for the plaintiffs in which a preliminary injunction was granted by a California state court against Brocade Communications Systems, a Delaware corporation, on April 10, 2012, two days before the annual meeting date.[5] By April 12, Brocade had made additional disclosures as requested and settled with the plaintiffs' lawyers for $625,000.[6]

In 2012, numerous lawsuits were brought against companies in state court between the filing and dissemination of their definitive proxy statement and the date of the annual meeting, asserting that the proxy statements did not provide adequate disclosure and alleging breach of fiduciary duty by directors.[7] Nearly all of these were filed by a single law firm, in some cases with the same plaintiff. Some targeted companies have defended themselves in court and successfully defeated attempts to seek injunctions against the shareholder votes in question, while others have settled. The settlements have resulted in additional disclosure by the target companies and six-figure legal fees for the plaintiffs' attorneys. One defense attorney summed up the current trend as "a shakedown for a quick buck."[8]

To date, there have been three types of shareholder votes targeted by these lawsuits: executive compensation arrangements, proposals to increase the number of authorized shares in the charter, and proposals to increase the equity plan share reserve. The allegations relating to executive compensation arrangements are that the company's proxy statement contains insufficient disclosure for the mandated say-on-pay proposal, thereby denying shareholders the opportunity to make an informed decision in their advisory vote. The allegations relating to an increase in authorized shares and in the equity plan share reserve tend to include, among other things, that the effect of the dilution caused by the increased shares has not been adequately disclosed. The complaints do not allege actual disclosure law violations but instead attempt to claim breach of fiduciary duty by the directors because of the supposedly insufficient disclosure in the definitive proxy statement.[9]

Disturbingly, the plaintiffs seek to examine board materials such as minutes, internal memos, compensation consultant reports and projections during the discovery process, looking for information that may have been discussed by the board or the compensation committee but was not included in the definitive proxy statement provided to shareholders.[10] This kind of discovery fishing expedition can lead to ever more intrusive inquiries and disclosure demands, effectively resulting in an unwelcome attempt to substitute plaintiffs' lawyers' self-serving interests for the business judgment of the board. To the extent that this type of litigation and the attendant discovery demands have a chilling effect on board discussions and internal processes, they undeniably harm the very shareholder interests they purport to defend.

Anticipating Disclosure Lawsuits

As companies prepare their proxy statements and look ahead to the 2013 proxy season, there are several steps that corporations can take to attempt to minimize exposure to this kind of lawsuit. First, required proxy disclosure should be transparent, thorough and in compliance with all applicable requirements. The basis for any executive pay changes should be clearly articulated and carefully explained. Companies that wish to increase available shares or authorize additional shares should review their disclosure on equity plans and set forth clear explanations as to why these shares are needed along with an analysis of the dilutive impact of the proposed share increase.

Second, companies may consider reducing the level of disclosure provided in the proxy statement regarding compensation committee deliberations. Plaintiffs in these cases have requested details such as specific financial metrics regarding the issuer's peer group and how the committee's compensation consultant has been selected and compensated.[11] Since these requests are not designed to obtain disclosure of required information but are in fact efforts to intimidate and harass a company into settlement, attempting to satisfy the plaintiffs' disclosure requests could result in a spiral of endless demands for disclosure of back-up information and data. It may be advisable, rather, for companies to remove quantitative data from their stock option plan proposals and minimize peer group references so as to give the plaintiffs' lawyers fewer openings for intrusive inquiry. Although it is unfortunate that the response to this litigation could be to put forth less disclosure, unless courts are willing to protect boards from these lawsuits, companies may be better served by limiting their disclosures and explanations to those required by the applicable disclosure rules. Moreover, corporate secretaries and boards should seek to build a strong record by drafting compensation committee and board minutes with the expectation that they will be reviewed by plaintiffs' counsel.

Third, the compensation committee and full board should be advised of the potential litigation risk during the proxy preparation process and should consult with outside counsel in order to be prepared to respond to a lawsuit if one is filed. It may be desirable to have outside securities litigation counsel review the draft proxy disclosures with an eye toward defending a potential lawsuit of this type. Counsel that has defended similar suits in the past or that is familiar with these lawsuits may be able to offer valuable advice that could forestall or be advantageous in defending a claim. The board should review with its internal counsel the timeline of such litigation, possible defenses to a proxy disclosure lawsuit, and strategies for litigation as well as the potential for settlement.

Doing so ahead of time gives directors the opportunity to consider, without the stress of a pending lawsuit, their appetite for fighting such litigation versus yielding to a quick settlement. Boards also can remove some of the time pressure imposed by these lawsuits by submitting equity plans for shareholder approval more than one year in advance and understanding any state law, bylaw or charter constraints on adjourning a shareholder vote to a later date.

Fourth, Delaware companies may consider adopting an exclusive forum bylaw. Delaware companies can adopt a bylaw—without shareholder approval—that all shareholder litigation (regarding state law claims) must occur in the state of incorporation. While these bylaws may not be enforceable in all jurisdictions if adopted by the board without shareholder approval,[12] nonetheless they may be helpful in this context. Delaware courts are widely recognized as competent, fair and experienced, and the body of case law is well-developed and carefully applied. Delaware judges have been rightly skeptical of lawsuits where the primary goal appears to be the receipt of lawyers' fees, and plaintiffs' attorneys will be unlikely to pursue this type of suit if they believe it will be adjudicated in the Delaware Court of Chancery. Indeed, the plaintiffs have chosen to bring these claims in state court (generally where the company is headquartered) but not in the Delaware Chancery Court, even when the targeted company is a Delaware corporation. Delaware, which has adjudicated most of the disclosure cases brought in the mergers-and-acquisitions context, would appear to be an inhospitable forum for baseless proxy disclosure litigation.

There has been a surge in the adoption of exclusive-forum provisions since 2010,[13] the year in which Dodd-Frank was enacted and in which Vice Chancellor Travis Laster commented in a footnote that "if boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, the corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes."[14] By adopting these bylaw provisions, Delaware corporations may decrease the likelihood of being sued in jurisdictions that have less experience in addressing these types of cases.

Finally, management and boards of directors may wish to review the terms of their directors' and officers' insurance policy to make sure that it is up-to-date and adequate for the corporation, given the company's size and potential for litigation exposure.[15] The

board (or a committee of the board) should review this coverage on an annual basis with the assistance of counsel.

The law firm that has filed most of these lawsuits has adopted a tactic of issuing a press release announcing a "notice of investigation" regarding the proxy statement disclosures of a potential targeted company.[16] This is intended to help the law firm find plaintiffs and push the targeted company toward a quick settlement. While some companies have agreed to settle these claims quickly, others have used this public warning to prepare to defend the litigation. Companies can use the opportunity to reach out to institutional shareholders or experts who might be called upon to submit declarations in opposition to a preliminary injunction motion. Some companies have also released supplemental disclosures in hopes of averting a lawsuit.[17] However, companies need to consider carefully the downside of making supplemental disclosures that could lead to the plaintiffs' firm making a fee application and citing the benefit that resulted to the plaintiff class from the additional disclosure made after the definitive proxy statement was released. Thus, companies should seek advice from litigation counsel as well as securities law counsel before making supplemental disclosure.

Companies that are sued in this context and decide to vigorously contest the allegations frequently have been successful. One tactic that has been helpful in some cases is to procure affidavits from significant institutional shareholders to counter the allegations. Such an affidavit can be very persuasive to a court; moreover, in our experience, institutional shareholders generally are not supportive of this type of litigation. Having an institutional shareholder submit a declaration gives the lawyer defending the company the ability to draw a sharp contrast between the interests of shareholders and the interests of plaintiffs' lawyers who file these lawsuits on behalf of small individual shareholders who often serve that function in multiple cases. Companies that engage regularly with their significant institutional shareholders are more likely to be able to leverage these relationships to procure support when confronted with these lawsuits. Companies have also successfully engaged experts in areas such as disclosure practices to effectively resist preliminary injunction motions. Prior planning is important to be able to marshal the resources necessary to defend against these lawsuits.

Looking Ahead

A couple of key points bear emphasis. One is that these proxy disclosure lawsuits do not concern or allege any actual violation of law or disclosure rules—they focus on alleged breaches of fiduciary duty by the board of directors. The other is that we do not believe that shareholders benefit from these lawsuits or settlements by obtaining either meaningfully enhanced disclosure or financial gain. This litigation is lawyer-driven, and the plaintiffs' attorneys appear to be the only material beneficiaries. Taken together, these facts indicate that full compliance with applicable disclosure requirements likely will not deter these lawsuits; rather, only a widespread refusal to settle, coupled with vigorous defenses and discouraging judicial results, will persuade these plaintiffs and their lawyers that these lawsuits—like the first round of say-on-pay litigation—are not worth pursuing.

The plaintiffs' lawyers filing these lawsuits expect to take advantage of the significant pressure on a board to settle quickly when faced with litigation that threatens to postpone the annual meeting of shareholders. In addressing the question of whether to settle, the board and management should discuss litigation concerns such as the cost of defense, the impact of discovery, and the risk of future suits. They should also consider the effect of making additional disclosure that is not required by applicable law and whether that will be beneficial to shareholders in the long term. Further, they should be aware of the potential risk to timely passage of contested annual meeting proposals. In addition to all of these immediate issues, however, they should also consider the company's business principles and ethics. Plaintiffs' lawyers who use the requirements of Dodd-Frank to attack companies are inhibiting the growth and prosperity of American business. As one prominent commentator recently opined:

> Say on pay was sold as an advisory process that would not change a board of directors' liability exposure. Plaintiff lawyers are trying to remake that bargain into a cash machine on which they will annually draw every proxy season. It's time to nip that effort in the bud. Throw these suits out of court and hit those who bring them with exemplary sanctions.[18]

Though the dollar amount of a proposed settlement may seem relatively insignificant, and though additional disclosures may appear harmless in and of themselves, boards may nonetheless determine that it would be beneficial to the company, its shareholders

and the corporate environment generally to defend such meritless suits vigorously and thereby do their part to deter future harassment of this type.

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Endnotes:

1. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173).

2. The only case in which the defendants' motion to dismiss was denied was the *Cincinnati Bell* decision under Ohio law. See The Corporate Counsel, September-October 2012, at 6 (referring to *NECA-IBEW Pension Fund v. Cox*, Case No. 1:11-cv-451 (S.D. Ohio 2011)).

3. The plaintiffs could also seek to enjoin the annual meeting itself, although such an approach would make it more difficult for the plaintiffs to prevail on the balance of hardships argument necessary to obtain an injunction. One of the authors recently participated in a webinar hosted by The Society of Corporate Secretaries and Governance Professionals. For additional information, see connect.governanceprofessionals.org/connect/resources/viewdocument?DocumentKey=d57baeee-a964-472c-b636-9a108aa90e1e (log-in required).

4. A recent study found that 96 percent of the transactions announced in 2011 were subject to litigation. See Cornerstone Research, Recent Developments in Shareholder Litigation Involving Mergers and Acquisitions (2012), available at www.cornerstone.com/files/News/16126ed6-7c79-4bf2-b3f0-5d6e260dbbf5/Presentation/NewsAttachment/43622c58-bce0-4c47-9164-7fc10e7a4836/Cornerstone_Research_Shareholder_MandA_Litigation.pdf.

5. *Stephen Knee v. Brocade Communications Sys.* (Case No.: 1-12-CV-220249).

6. See The Corporate Counsel, September-October 2012, at 6; see also Brocade Communications Systems, Press Release, Oct. 5, 2012.

7. See David F. Larcker and Brian Tayan, "Shareholder Lawsuits: Where Is the Line Between Legitimate and Frivolous?" Stanford Closer Look Series, Nov. 27, 2012, at 2 ("[I]n 2012 alone, the law firm Faruqi & Faruqi has filed over 33 lawsuits for inadequate disclosure").

8. See Nate Raymond, "Lawyers Gain From Say-on-Pay Suits Targeting U.S. Firms," Reuters.com, Nov. 30, 2012 (quoting Boris Feldman of Wilson, Sonsini, Goodrich & Rosati), available at www.reuters.com/article/2012/11/30/us-usa-shareholders-sayonpay-idUSBRE8AT09M20121130; see also Reynolds Holding, "Say on Prey: Shareholder Votes will be a Feast for Legal Eagles," Reuters Breakingviews (Jan. 4, 2013), available at newsandinsight.thomsonreuters.com/Legal/News/2013/01_-_January/Breakingviews__Shareholder_votes_will_be_a_feast_for_legal_eagles/.

9. See The Corporate Counsel, November-December 2012, at 5-6.

10. See id.

11. See id.

12. Some Delaware corporations have sought shareholder approval to adopt exclusive forum provisions, particularly after a 2011 decision by the Northern District of California that refused to enforce Delaware corporation Oracle's bylaw. See *Galaviz v. Berg*, 763 F. Supp. 2d 1170 (N.D. Cal. Jan. 3, 2011). While shareholders generally have approved such provisions (for example, in 2011 and 2012, five out of six public companies' proposed exclusive forum provisions were approved by shareholders), opposition from shareholder activist groups has intensified. Furthermore, in 2012 there were, for the first time, four shareholder proposals to eliminate board-adopted exclusive forum provisions, though both of the proposals that went to a vote failed. See "2012 Proxy Season Review," Sullivan & Cromwell, June 9, 2012, at 13-14; "Implementing Exclusive Forum Selection Clauses: Now or Never?" Wiggin & Dana, May 1, 2012. Indeed, a proposal seeking shareholder approval for an exclusive forum provision could itself become the subject of a proxy disclosure lawsuit. That said, shareholder approval is not required for the adoption of exclusive forum bylaws, and their enforceability in other jurisdictions is likely to become clearer over time.

13. One source states that before 2010, only 16 Delaware companies had adopted exclusive-forum provisions in their bylaws or charters, whereas by the end of 2011, around 200 had done so. See Ashley Post, "Shareholders Sue Over Exclusive-Forum Bylaws," www.insidecounsel.com, May 30, 2012 (citing Professor Joseph Grundfest, delivering the Delaware Journal of Corporate Law's annual Pileggi Lecture).

14. *In re Revlon S'holders Litig.*, 990 A.3d 940, 961 n.8 (Del. Ch. March 16, 2010).