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Proxy Season Brings a Third Wave of "Gotcha" Shareholder Litigation

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Proxy season is upon us and the plaintiffs' bar is demonstrating its resourcefulness by bringing a third wave of shareholder litigation. This new wave, which has not crested yet, consists of a return to derivative shareholder suits but no longer concerning say-on-pay votes. Instead, these lawsuits are focused on "gotcha" allegations that companies issued stock options or restricted stock units to executives in amounts that exceed the limits of those companies' stock plans. These lawsuits are easily preventable with careful planning by Compensation Committees and their in-house and outside counsel to ensure that all stock grants and executive compensation proposals are in compliance with the company's stock plan.

Since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010 ("Dodd-Frank Act"), which requires a say-on-pay advisory vote on executive compensation, the plaintiffs' securities bar has been busy filing lawsuits and issuing press releases "investigating" companies concerning say-on-pay votes and/or executive compensation matters. As discussed in our November 19, 2012 Client Alert, Plaintiffs' Firms Gaining Steam in New Wave of Say-on-Pay Shareholder Suits?, there have been two distinct waves of shareholder litigation over the past couple of years. Now, there has been a third one consisting of derivative shareholder suits alleging that companies approved executive compensation in violation of stock plans.

First Wave Peaked in the Third Quarter of 2011: Derivative Shareholder Suits Following Failed Say-on-Pay Vote

After say-on-pay advisory votes became required, few companies have had shareholder votes that did not approve the proposed executive compensation arrangements. Specifically, only 57 out of 2215 companies

(2.6%) had such failed say-on-pay votes in 2012.[1] Many of those companies approved the executive compensation subject to the failed say-on-pay vote and quite a few of those companies were targeted with derivative shareholder litigation. Shareholders have sued 22 companies with failed say-on-pay votes. Shareholders sued 15 of 43 companies (35%) with failed say-on-pay votes in 2011 and 4 out of 57 companies (7%) with failed say-on-pay votes in 2012. Those actions generally alleged that boards of directors breached their fiduciary duties by approving executive compensation arrangements that shareholders did not approve in their non-binding, advisory vote. They peaked in the third quarter of 2011 and none have been filed since a few stragglers were filed in the third quarter of 2012.

As indicated in the Appendices, courts have dismissed 50% of these cases on motions to dismiss for two primary reasons. First, these suits failed to plead that plaintiffs were excused from the pre-suit requirement of making a demand on the board of directors to bring suit. Second, courts recognized that a say-on-pay vote is purely advisory and non-binding on boards of directors. Several of those decisions are on appeal. In addition, 18.5% of the cases have settled with some resulting in very significant attorneys' fees awards. 27% of the suits are still pending. These cases have been filed all over the United States, with California, Delaware and Texas courts being the most popular.

Second Wave Peaked in the Fourth Quarter of 2012: Putative Class Actions to Enjoin Annual Meetings

The plaintiffs' central allegation is inadequate disclosure of executive compensation matters in proxy statements, which justifies enjoining the annual shareholder meeting. A significant part of the second wave included a blizzard of press releases targeting 73 companies by plaintiffs' law firms which contended that they were "investigating" executive compensation matters. Of course, such press releases often are issued to dig up a shareholder of the target company who could serve as a figurehead plaintiff in a lawsuit and/or to terrorize the targeted company with imminent litigation to disrupt the timing of the annual meeting.

Only a small percentage of the companies targeted by "investigatory" press releases actually were sued. Of the 73 companies targeted, 14 companies eventually were sued and an additional 10 companies were the subject of litigation without the issuance of any "investigatory" press release. As indicated in the Appendices, 33.5% of the cases resulted in a denial of a motion for preliminary injunction and 17% of the cases were voluntarily dismissed. 33.5% of these cases have been settled prior to a ruling on a preliminary injunction motion, with settlements consisting of enhancements to disclosures in proxy statements coupled with cash payments of attorneys' fees. Unsurprisingly, a large chunk of these cases, 32%, are pending – even after denial of plaintiffs' preliminary injunction motions.

In those cases in which motions for preliminary injunction were defeated, courts found that there would be no irreparable injury should the annual meeting proceed as scheduled. A critical component appears to be an expert declaration from a Stanford professor in support of the company's disclosures in the proxy statement. While the preliminary injunction may have been defeated and no disruption to the annual meeting schedule occurred, those cases have not yet been dismissed. There are a number of motions to dismiss pending in those cases, and it remains to be seen if those motions will be successful or if courts will require discovery to proceed.

As indicated in the Appendices, these cases have been filed all over the United States, with California and New York courts being the most popular.

[1] Semler Brossy, 2012 Say-On-Pay Results (12/31/12), available at http://www.semlerbrossy.com/wp-content/uploads/2013/01/SBCG-SOP-Year-End-Report.pdf

Second Wave May Have Resulted in Non-Public, Individual Settlements Prior to the Initiation of Litigation

Press articles and statements from lawyers at other law firms indicate anecdotal evidence that some of the second wave suits may have been settled on an individual, rather than class-wide, basis prior to the filing of litigation. In order to evaluate the truth of these assertions, we evaluated whether the 59 companies targeted by an "investigatory" press release from the plaintiffs' bar and which subsequently were not sued may have issued enhanced disclosures on executive compensation matters in their proxy statements prior to scheduled annual meetings. Our review indicated that there were 5 companies that did issue enhanced disclosures concerning executive compensation matters. This enhanced disclosure could have been in response to the issuance of the press release in an attempt to fend off actual litigation or it could have been consideration for an individual settlement or a response to a shareholder's letter or demand to a company's board of directors to investigate executive compensation matters.

If these augmented disclosures formed the basis for an individual, out-of-court settlement, such settlements likely would consist of those disclosures and a cash payment for attorneys' fees. Such settlements, however, could not contain releases that would be binding on other shareholders of those companies because no court would have approved those settlements. While one law firm dominated in the initiation of the second wave of lawsuits, there are two other firms involved in initiating litigation or issuing press releases relating to this second wave. As a result, companies electing to settle such matters on an individual basis without court approval run the risk of settling with one law firm on behalf of one shareholder and then either having that same law firm represent a different shareholder in making a similar claim or having another law firm file suit for the same matters. In addition, companies electing to settle such matters on an individual basis may have a heightened risk of being targeted as easy marks by plaintiffs' law firms every time proxy season rolls around or in future potential securities litigation about other matters. In the long run, not settling but instead litigating and winning will be less expensive than a one-time cheap settlement because it will deter future litigation.

Third Wave Emerged in the Third and Fourth Quarters of 2012: Derivative Shareholder "Gotcha" Suits

It is laudable that companies fought plaintiffs on motions for preliminary injunctions in the second wave of cases. Due to those efforts, the plaintiffs' bar was beaten in 80% of motions for preliminary injunction. As a result, the plaintiffs' bar has turned to a new area of focus. In the past two quarters, 10 companies have been targeted by derivative shareholder litigation alleging that those companies awarded executive compensation in violation of stock plans and thus filed purportedly false and misleading proxy statements. These lawsuits are not linked to an upcoming annual meeting or say-on-pay vote. If the allegations are true, these suits stand a higher probability of success than the two prior litigation waves. As reflected in the Appendices, the favorite venue is the U.S. District Court for the District of Delaware, in which six of these cases have been filed. It is too soon to tell how these suits will be resolved and if motions to dismiss on the grounds of failure to plead demand futility – a very successful tactic in defending any derivative litigation, and particularly successful in defeating 50% of the cases filed in the first wave – will be equally successful with these cases. It is also too soon to tell if plaintiffs' allegations based on reading the relevant plans and examining the awarded executive compensation are correct or based on erroneous analysis.

Role of Institutional Investors

In reviewing the cases filed in all three waves of shareholder litigation concerning executive compensation, we evaluated the role of institutional investors. Institutional investors have been plaintiffs in some cases, but have also supported defendant companies in others.

After the passage of the Private Securities Litigation Reform Act ("PSLRA") in 1995, plaintiffs' law firms courted institutional investors to serve as named plaintiffs in class actions to better position those plaintiffs and the law firms representing them to be appointed "lead plaintiff" and "lead plaintiffs' counsel" in those cases. The appointment as "lead plaintiffs' counsel" ensures that the chosen counsel directs and controls the litigation and captures a large portion of any attorneys' fees awarded at the conclusion of a successful case. Here is the breakdown of derivative and putative class action complaints filed by institutional investors in all three litigation waves:

First: 10 institutional investors (32% of all complaints)

Second: 1 institutional investor (4% of all complaints)

Third: 4 institutional investors (29% of all complaints)

No single institutional investor filed more than one complaint in the three waves. The lack of enthusiasm among institutional investors to be the plaintiff in the second wave of cases – the putative class actions seeking to enjoin annual meetings – may indicate one of two things. One possibility is that institutional investors looked askance at the allegations of those suits and did not want to be involved. The other possibility is that the dominant law firm involved in filing practically all of the second wave suits did not have relationships with institutional investors that fostered reaching out to those investors to serve as plaintiffs in lawsuits.

On the flip side, at least one institutional investor, a large California pension fund, has filed a declaration in support of a technology company's proxy statement disclosures in a second wave case. That declaration undoubtedly supplied powerful motivation for the plaintiff to then voluntarily dismiss the suit prior to a hearing on the preliminary injunction motion.

Should institutional investors view these suits as not adding value to shareholders by seeking additional disclosures in proxy statements that are not meaningful, they would be well advised to take a stand and support issuers on their disclosures. From an investor's perspective, litigation initiated by shareholders that costs companies money to resolve and defend and adds nothing of value to proxy statements are not in the best interests of shareholders. Hopefully, more institutional investors will consider actively supporting companies in these lawsuits.

Prevention and Exit Strategies

As we discussed in our earlier alert, the first wave of shareholder litigation is over although cases will continue to wind their way through congested court dockets for some time. No amount of additional disclosure in proxy statements will prevent companies from being sued in the second wave of these lawyer-driven actions. Rather, plaintiffs' counsel will poke holes and allege that additional disclosure is required no matter what is contained in the company's proxy statements. It goes without saying that strong disclosures will put companies in a better position to defeat these actions.

The third wave of litigation, however, is entirely preventable. If the allegations are true that companies issued stock options to executives in excess of limits authorized by the relevant plans, then those actions could have been prevented by complying with all limits established by the plans. As always, careful review of executive compensation actions by in-house and outside counsel and compensation consultants should ensure compliance with all governing plans.

Finally, we recently have seen the filing of a combined shareholder derivative and class action in a different court as a tag-along to a derivative lawsuit filed as part of the third litigation wave. Of course, it has been a fact of life for some time that securities litigation generally has involved multiple actions – lawsuits filed in state and federal courts and a putative class action being accompanied by a tag-along derivative suit. Where derivative litigation is filed, it often has involved a law firm representing a shareholder in making a direct demand on a company's board of directors to investigate the subject matter of litigation filed by a different plaintiffs' law firm. Of course, the point of all of this separate litigation is to have more plaintiffs' law firms attempting to profit by being a part of any global resolution of these actions. This latest tactic may be a harbinger of the kind of multiple litigation in different forums, coupled with potential shareholder demands, that is all too familiar in the securities litigation landscape.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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APPENDIX OF FIRST WAVE CASES:
Say-on-Pay Derivative Shareholder Suits Against 22 Companies

Disposition of Cases	**No. of Cases**	**Percentage**
Settled after Motion to Dismiss Denied	1	4.5%
Settled with No Ruling on Motion to Dismiss	3	14%
Motion to Dismiss Granted and Final	9	41%
Motion to Dismiss Granted But Not Final Disposition	2	9%
Pending	6	27%
Voluntary Dismissal	1	4.5%
Total	22	100%

Courts Granting Motions to Dismiss
U.S. District Court – N.D. California – 2 cases
U.S. District Court – S.D. California (on appeal)
U.S. District Court – Colorado
U.S. District Court – N.D. Illinois
U.S. District Court – Maryland
U.S. District Court – E.D. North Carolina
U.S. District Court – Oregon
U.S. District Court – S.D. Texas
Georgia Superior Court
California Superior Court – Los Angeles County (on appeal)

Courts Denying Motion to Dismiss
U.S. District Court – S.D. Ohio

Jurisdiction[1]	**No. of Cases**
U.S. District Court – N.D. California	2
U.S. District Court – S.D. California (two state court cases removed and consolidated, then remanded to California Superior Court – San Diego County)	1
U.S. District Court – Colorado (2 cases consolidated)	1
U.S. District Court – Delaware	3
U.S. District Court – N.D. Illinois	1
U.S. District Court – Maryland	1

[1] In numerous circumstances, plaintiffs filed suits in multiple courts. Consolidated cases are listed as a single case. Cases not subsequently consolidated are counted separately.

U.S. District Court – New Jersey	1
U.S. District Court – S.D. New York (3 cases consolidated)	1
U.S. District Court – E.D. North Carolina	1
U.S. District Court – N.D. Ohio (4 cases – 3 of which were consolidated)	2
U.S. District Court – S.D. Ohio	1
U.S. District Court – Oregon	1
U.S. District Court – S.D. Texas	3
California Superior Court – Los Angeles County	2
Delaware Court of Chancery (2 cases consolidated)	1
Georgia Superior Court – Fulton County	1
Texas State Court – Harris County	2

APPENDIX OF SECOND WAVE CASES:
Putative Class Actions Seeking Injunctive Relief Against 24 Companies

Disposition	No. of Cases	Percentage
Plaintiffs' motion for preliminary injunction granted ▪ 1 case subsequently settled ▪ 1 case is still pending	2	8%
Plaintiffs' motion for preliminary injunction denied ▪ 5 cases are still pending ▪ 3 cases were subsequently dismissed voluntarily by plaintiffs	8	33.5%
No ruling on any motion for preliminary injunction	2	8%
Settled prior to ruling on plaintiffs' motion for preliminary injunction	8	33.5%
Plaintiff voluntarily dismissed case without settlement (excluding two cases voluntarily dismissed after denial of motion for preliminary injunction)	4	17%
Total	24	100%

Courts Granting Motions for Preliminary Injunction
California Superior Court – Santa Clara County
U.S. District Court – N.D. California

Courts Denying Motions for Preliminary Injunction
California Superior Court – Santa Clara County – 2 cases
California Superior Court – Alameda County
California Superior Court – Santa Cruz County
New York Supreme Court – Nassau County
New York Supreme Court – Suffolk County
U.S. District Court – N.D. California
U.S. District Court – N.D. Illinois

Jurisdiction	No. of Cases
California Superior Court – Alameda County	1
California Superior Court – San Diego County	1
California Superior Court – Santa Clara County (one of which was remanded back from U.S. District Court – N.D. Cal.)	5
California Superior Court – Santa Cruz County	1
Arizona Superior Court – Maricopa County	1
Circuit Court of Missouri – Jackson County	1
New York Supreme Court – New York County	4
New York Supreme Court – Suffolk County	1
New York Supreme Court – Albany County	1
New York Supreme Court – Nassau County	1
Washington Superior Court – King County	1
U.S. District Court – N.D. California	1
U.S. District Court – N.D. Illinois (after removal from Illinois state court)	1
U.S. District Court – New Jersey	1
U.S. District Court – S.D. New York	2
U.S. District Court – Utah	1
Total	24

APPENDIX OF THIRD WAVE CASES:
Recent Derivative Shareholder Suits against 11 Companies

Jurisdiction[1]	No. of Cases
New York Supreme Court – New York County	1
Delaware Court of Chancery	1
U.S. District Court – C.D. California (2 cases pending against one company with a pending motion to consolidate)	2
U.S. District Court – Delaware (2 of these cases are pending against one company)	6
U.S. District Court – N.D. Illinois	1
U.S. District Court – Nevada	1
U.S. District Court – E.D. Pennsylvania	1
Total	13