

Executive Compensation and Benefits Alert

January 15, 2013

If you have any questions regarding the matters discussed in this memorandum, please contact any of the attorneys listed on page 3, or call your regular Skadden contact.

Annual Meeting Litigation: How to Prepare

As the 2013 proxy season is now underway, companies should be aware of the recent wave of lawsuits alleging breaches of fiduciary duties by management and directors in connection with compensation-related decisions. These suits allege deficient disclosure with respect to compensation-related proxy proposals and seek to enjoin the company's annual meeting until supplemental disclosures are made. They primarily target proposals to increase the amount of shares reserved for equity compensation plans and advisory votes on executive compensation (say-on-pay). There also have been a handful of suits relating to proposals seeking to amend certificates of incorporation to increase the total number of authorized shares.

More than 20 such cases were filed in 2012, and the plaintiffs' law firm predominantly initiating these suits has announced that it is investigating nearly 40 additional companies. These cases are typically filed shortly after a company files its definitive proxy statement and make generic accusations of inadequate disclosure. Some companies concerned about potential disruption to their annual meetings have been willing to settle these claims. There have been at least six reported settlements, all involving proposals to increase the number of shares authorized under equity plans. These settlements have generally involved supplemental disclosure and payment of up to \$625,000 of plaintiffs' attorneys' fees. Other companies have settled prior to the filing of a formal lawsuit. Although a preliminary injunction has been granted in only one of these cases, *Knee v. Brocade Communications Systems, Inc.*, many cases in which preliminary injunctions were denied are still pending resolution regarding other relief requested by the plaintiffs, such as damages. An analysis of the claims made in filed cases to date may help companies decide whether to increase disclosure in their 2013 annual meeting proxy statements.

Legal Theory

These cases are generally brought as class actions in the state court in which the company's principal place of business is located. The demands for additional disclosures are not based on allegations of deficient disclosure under SEC rules, but rather on the theory that a director may breach his or her state-law fiduciary duties by failing to disclose material information in connection with a request for shareholder action. Plaintiffs claim that a litany of additional information is necessary for shareholders to make an informed vote.

In *Boxer v. Accuray*, the defendant argued that the advisory say-on-pay vote, imposed under the federal Dodd-Frank Act, should be litigated under federal law and had the case removed to federal court. The U.S. District Court judge, however, remanded the case to California Superior Court, holding that Accuray had made "no showing that a violation of the Dodd-Frank Act with respect to disclosures in a proxy statement is a necessary prerequisite to [sic] finding of materiality — or a

Four Times Square
New York, NY 10036
212.735.3000

WWW.SKADDEN.COM

board member's breach of fiduciary duty."¹ The judge also noted that disclosure related to proposals to increase the number of authorized shares is a state law issue. Based on this holding, companies should be prepared to defend these types of lawsuits, particularly those involving increasing the number of shares available under an equity plan or the total number of authorized shares under a company's certificate of incorporation, on state-law materiality standards.

Claims Made by Plaintiffs

Alleged Deficiencies in Disclosures Related to Advisory Votes on Executive Compensation

1. General Pay Practices:

- The reasons that the company selected the particular mix of salary, cash incentive compensation, equity incentive compensation, and short-term and long-term compensation.
- How the compensation committee weighed the various performance measures used to determine the compensation of the company's executive officers.
- The criteria used by the compensation committee to establish or shift the target pay positioning of executive officers for various compensation components and how much weight each factor was given.
- The projected stock or option grants.
- How the board determined the company's stock ownership guidelines for its executive officers.

2. Peer Company Benchmarking and Survey Data:

- The criteria for selecting or removing peer companies used by the compensation committee to target the company's executive compensation.
- A summary of the compensation data for this peer group and the survey data the compensation committee used to target the company's executive compensation.
- The reason the compensation committee chose to benchmark its compensation at a certain level.
- The company's burn rate compared to the peer group or survey data analyzed by the board.

3. Compensation Consultants:

- The reasons the board selected and/or changed its compensation consultant or the underlying rationale for the board's decision not to use a compensation consultant.
- A fair summary of the advice and counsel of and analyses performed by the compensation consultant and provided to the board.
- The amount of fees paid to the compensation consultant and the other consulting and business services, if any, that the consultant provided to the company's management.

Alleged Deficiencies in Disclosures Related to New or Amended Equity Plans and Proposals to Increase the Total Number of Authorized Shares

- The criteria to implement the proposal, why it would be in the best interest of shareholders and the effect on shareholders.
- How the board determined the number of additional shares to be authorized, including equity grant projections.
- The timing of the issuance and the potential equity value and/or costs of the issuance of the additional authorized shares.

¹ *Boxer v. Accuray*, No. 12-cv-05722-SBA (N.D. Cal. Oakland Div.).

- The dilutive impact that issuing additional shares may have on existing shareholders and the amount of planned additional stock repurchases.
- The company's gross burn rate, net burn rate and overhang compared to the compensation peer group or the survey data used to formulate the overall size of the plan.

How to Prepare

In reality, no amount of disclosure will fully protect a company from these types of suits. Nonetheless, clients should consider enhancing disclosure relating to the areas that have been most susceptible to plaintiffs' attacks. In particular, companies including proposals to increase the number of shares authorized under their equity plans may want to address the dilutive effect of the plan on shareholders. Companies should also pay particular attention to the requirements of Items 402 and 407 of Regulation S-K and Item 10 of Schedule 14A to ensure full compliance with these rules. While there is no panacea that will eliminate the chances of being sued, careful drafting and attention to the issues raised in these cases will improve the likelihood that a company will avoid, or at least be successful in, such litigation.

If you have any questions regarding the matters discussed in this memorandum, please contact any of the attorneys listed below or call your regular Skadden contact.

Boston

Timothy F. Nelson	617.573.4817	timothy.nelson@skadden.com
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Los Angeles

Barbara Mirza	213.687.5614	barbara.mirza@skadden.com
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New York

Neil M. Leff	212.735.3269	neil.leff@skadden.com
Regina Olshan	212.735.3963	regina.olshan@skadden.com
Erica Schohn	212.735.2823	erica.schohn@skadden.com
Berit R. Freeman	212.735.2112	berit.freeman@skadden.com
David C. Olstein	212.735.2627	david.olstein@skadden.com

Palo Alto

Joseph M. Yaffe	650.470.4650	joseph.yaffe@skadden.com
Kristin M. Davis	650.470.4568	kristin.davis@skadden.com
Alessandra K. Murata	650.470.3194	alessandra.murata@skadden.com
Emily E. Cabrera	650.470.4639	emily.cabrera@skadden.com

Washington, D.C.

Michael R. Bergmann	202.371.7133	michael.bergmann@skadden.com
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