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Impact of Compensation-Related Litigation on Public Companies

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Compensation-related litigation and threats of litigation continued to significantly impact public companies in 2017. These companies should be mindful of issues that were raised in recent litigation: proxy disclosure, director compensation issues and the short-swing profit rules of Section 16 of the Securities Exchange Act.

Proxy Disclosure Litigation

Background. Public companies must adequately disclose information required by the compensation-related disclosure rules contained in Item 402 of Regulation S-K, including the rules relating to perquisites.

Overview of Litigation. In January 2017, the Securities and Exchange Commission (SEC) issued an order instituting cease-and-desist proceedings against MDC Partners for failure to disclose over $11million in perquisites paid from 2009 to 2014 to its then-CEO. The SEC's order also found that MDC separately violated non-GAAP (generally accepted accounting principles) financial measure disclosure rules. MDC took a number of remedial actions and paid a $1.5 million penalty to settle the charges.

In May 2017, the SEC issued a separate order against the CEO alleging that he knew, or was reckless in not knowing, that the proxy statements contained materially false and misleading executive compensation disclosures, and that they omitted numerous personal expenses for which he sought reimbursement as business expenses. The SEC's order noted that the CEO also submitted unsubstantiated expenses outside of MDC's expense reimbursement process and failed to disclose perquisites in his director and officer questionnaires. The CEO agreed to repay the perquisites and personal expense reimbursements, pay $5.5 million in disgorgement and penalties to the SEC, and be barred from serving as an officer or director of a public company for five years.

Takeaway. Public companies must carefully comply with perquisite disclosure rules — a relatively tricky area of disclosure. In practice, it can be difficult to determine whether a benefit is a perquisite. Although the SEC has provided general principles and interpretive guidance, companies must analyze the applicable facts and circumstances in order to determine whether a benefit is a perquisite, and significant grey areas remain. Once the determination has been made, the disclosure rules themselves are also rather complicated, and care must be taken to ensure compliance.

Intel's Equity Plan Lawsuit

Background. Preparing and amending equity plans is time-consuming, and care must be given to the disclosure of the equity plan proposal for stockholder approval. Proposals to approve new or amended equity incentive plans are highly scrutinized by proxy advisory firms, institutional investors and other stockholders. (See our January 26, 2017, client alert "Avoiding an ISS Negative Recommendation: Considerations for Companies Seeking Shareholder Approval of Equity Incentive Plan Proposals.")

Overview of Litigation. Intel sought stockholder approval in 2017 for an amendment to its equity incentive plan. The proposal indicated that eligible participants included Intel's nonemployee directors and all of Intel's full-time and part-time employees, where legally eligible to participate, and that approximately 84 percent of Intel's employees received an equity award in 2016.

In April 2017, a stockholder plaintiff alleged that, despite this level of detail, the proxy statement was deficient because it did not identify the actual number of employees who were eligible to participate in the plan, as required under Item 10(a)(1) of Schedule 14A of the Securities Exchange Act. The complaint noted that Intel's prior proxy statement seeking approval of its equity incentive plan included this information.

The stockholder plaintiff ultimately dismissed the case without prejudice. Other companies have encountered similar claims recently in connection with equity plan proposals.

Takeaway. When seeking stockholder approval for a new or amended equity incentive plan, companies must include all information required by Item 10 of Schedule 14A of the Securities Exchange Act.

Director Compensation

Background. In Delaware, claims involving director conduct generally are subject to review under a deferential standard known as the "business judgment rule." However, claims relating to director compensation are typically reviewed under a stricter "entire fairness" test, which requires directors to bear the burden of proving that a compensation decision was entirely fair to the corporation. A board of directors can avail itself of the business judgment rule in those circumstances if the challenged decision was ratified by a vote of fully informed stockholders. Previously, the Delaware Court of Chancery had held that stockholder approval of a discretionary equity plan could constitute "ratification" if the equity plan contained a "meaningful limit" on director compensation.

Overview of Litigation. In December 2017, the Delaware Supreme Court issued an opinion, *In re Investors Bancorp, Inc. Stockholder Litigation*, holding that, except under limited circumstances, the court will not apply the deferential business judgment rule in reviewing challenges to director awards granted pursuant to stockholder-approved equity plans. In this case, the board of directors submitted for stockholder approval an equity plan that imposed an aggregate limit on awards that could be granted to nonemployee directors. The company's stockholders approved the plan, and the board members awarded themselves as a group approximately $51.5 million in equity awards. The plaintiff alleged that the directors' compensation exceeded the compensation paid to directors of peer companies. The court held that the stockholder ratification defense was not available to the board of directors to dismiss the case because the equity plan granted discretion to the directors to approve specific awards. According to the Delaware Supreme Court, stockholder ratification is a permissible defense only in two scenarios: (1) when stockholders approve specific director awards, and (2) when the equity plan is a self-executing formula plan, such that the directors have no discretion in granting the awards to themselves. If directors retain discretion to make awards under the general parameters of a plan — even when the parameters are specific to directors — then ratification cannot be used to obtain the benefit of the business judgment rule standard of review for a breach of fiduciary duty claim.

Takeaway. Public companies should work with their compensation consultants to conduct a peer review of their director compensation programs in order to determine whether equity grants are reasonable. Companies should carefully document this process and consider the extent to which it may be beneficial to describe the process in their annual proxy disclosure, particularly in light of increased scrutiny of director compensation programs by institutional stockholders. (See our November 20, 2017, client alert "ISS Announces 2018 Updates to US Proxy Voting Guidelines.") In light of the Delaware Supreme Court's opinion, companies should consider whether to provide for grants of director equity awards in a stockholder-approved formula plan or seek shareholder approval of specific grants of awards to directors.

Section 16 Litigation

Background. Under Section 16(b) of the Securities Exchange Act, a public company's officers and directors ("insiders") are generally required to disgorge any profit from purchasing and selling company securities within six months. Typically exempt from this short-swing profit rule are grants of company equity awards and the withholding of shares to cover related taxes or the applicable exercise price (*i.e.*, net share settlement). To qualify for the exemption, the board of directors or compensation committee typically approves such transactions in advance, as contemplated by Rules 16b-3(d)(1) and 16b-3(e). This exemption generally requires that the committee's advance approval be specific to a transaction. Any grant of this decision-making power to "the company" may be viewed as too vague. Plaintiffs have recently challenged the effectiveness of approvals under Rule 16b-3(e) on grounds of both insufficient specificity and improper implementation.

Overview of Litigation. Plaintiffs have contested instances of net share settlement by alleging that the compensation committee did not approve the settlement with sufficient specificity, that the compensation committee's grant of discretion to the insider was insufficient or that a net share settlement as ultimately effected was outside the scope of the terms approved in advance. Plaintiffs assert that such net share settlements are not exempt from Section 16 and seek to match those alleged sales against insiders' purchases.

Takeaway. Preapproval by the compensation committee of the specific terms of each net share settlement would eliminate the risk of these claims. However, neither the SEC nor the courts require this level of specific preapproval. Companies should review their award agreements and resolutions relating to net share settlement or share tax withholding provisions to ensure compliance with the Section 16 rules.

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