"The Litigation Explosion in Executive Compensation"

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Course Materials

Audio Archive

Over the past year, there have been a rash of lawsuits filed over perceived defects in executive pay plans and disclosures - some related to say-on-pay, some that aren't. In this webcast, learn what is involved in these lawsuits, as well as how to handle them, by hearing the analysis as these experts run through a number of specific common scenarios in these suits:

- **Rick Gallagher**, Partner, Orrick, Herrington & Sutcliffe LLP
- **Joe McLaughlin**, Partner, Simpson Thacher & Bartlett LLP
- **Mark Poerio**, Partner, Paul, Hastings, Janofsky & Walker LLP

Broc Romanek, *Editor, CompensationsStandards.com*: Welcome to today's program, "The Litigation Explosion in Executive Compensation."

First thing you should do, if you haven't done it already, is print off the course materials, which is a PowerPoint that our panelists have put together. Just click on the link called "Course Materials" on the page where you accessed this webcast and print that off, so you can take notes along the way. The panelists will refer to the slides as they go.

Let me go ahead and introduce our panelists. Rick Gallagher is a Partner at Orrick out on the West Coast. I thought it was important to have someone on the West Coast on this program, since a lot of the lawsuits being filed involve companies out there. Also on the panel are Joe McLaughlin, who's a Partner at Simpson Thacher up in New York, and Mark Poerio, who's a Partner at Paul Hastings here in D.C. Thanks to Mark for driving the process of putting together the PowerPoint.

I'll turn it over to first to Rick to talk about say-on-pay litigation and the recent injunction cases.

Say-on-Pay Litigation and Recent Injunction Cases

Rick Gallagher, *Partner, Orrick, Herrington & Sutcliffe LLP:* Thanks, Broc. I also think it's good to have some West Coast representation on this panel, because this latest wave of say-on-pay and injunction suits has been mostly focused in California.

I think most people will remember the wave of cases last year, when the first "no" votes on say-on-pay started coming out, and a couple of dozen companies were hit with suits simply over the fact that there was a "no" vote. Almost all of those suits either failed or ended up in nominal settlements. Cincinnati Bell was the one that people were looking at and wondering if those cases were going to proliferate, but it never really had legs.

We saw a morphing of the attention in the say-on-pay area into a new theory in 2012 and continuing into this year. There have been about 15 companies that have been sued. These cases are basically about disclosures. The claims involve inadequate disclosures in the proxy statement relating to equity compensation plan votes or say-on-pay votes.

Most of the cases have been filed by the Faruqi & Faruqi law firm. They have taken a page out of the M&A litigation playbook, so the cases are very familiar, in the way they proceed, to those of us that do a lot of merger litigation.

What typically happens is, as you get close to the shareholder vote - in many of the cases, as late as the day before or a couple days before the meeting - the plaintiffs will go into state court to try and enjoin the vote. Many of these cases have been brought here in Silicon Valley in front of Judge Kleinberg and others. The claims typically will allege that there is no adequate disclosure, for example, as to why the share reserve is being increased, or why a company is using a 75% benchmark, or something like that. (The examples I gave are two of the main disclosures that have been attacked.)

The last time I did a review I found nine cases that had actually gone to a hearing in court and come out with a decision. The companies I'm aware of that have gone to a decision are AAR, Symantec, Cisco, Clorox, Brocade, Globecon, Dex One, Ultratech, and Hain, which was in New York.

For the most part, the plaintiffs have lost at the injunctive stage. The judges have followed a similar rationale in rejecting these challenges. One of the main items that the judges have been relying on is the fact that the say-on-pay votes are nonbinding advisory votes. So it's very difficult, if not impossible, for the plaintiffs to show that there is any sort of irreparable harm that would come about if these allegedly defective disclosures went forward. It's hard to show what the potential damage would be.

In fact, a couple of the judges have said, "Even if we assume that the disclosures were defective, couldn't you just have another vote later on?" And the answer really is, "Yes." So it's hard for plaintiffs to hold up the vote on that basis.

The other main item that the judges have been looking at in rejecting these challenges is the fact that Dodd-Frank doesn't require these pieces of information - the details underlying compensation consultant advice, or the comparables that have been chosen, or other details underlying the disclosures. Dodd-Frank doesn't require those things be disclosed, and Item 402 of Regulation S-K doesn't say anything specifically about these various details either. So the judges have been unwilling to enjoin any of the votes, based on the lack of any precedent requiring that.

I wanted to make a couple of additional points, and then we'll move on to the say-on-parachute discussion. There are a couple of different things that companies should be doing to prepare for these potential cases.

First, they need to be looking at having somebody familiar with litigation and cases in this area taking part in preparing the disclosures. I'll speak briefly in a minute about some of the things to look at and consider in making the disclosures.

Second, once the disclosures have been made and you're waiting to see whether there's going to be any litigation, you should be tracking whether or not there is a shareholder investigation that has been announced by Faruqi or another law firm, which is sort of a leading indicator that your company or your client is probably going to be sued - or at least there's a significant likelihood that it is going to be sued. Once you know that you're in the bull's-eye, so to speak, you can take certain steps to be prepared if the complaint is filed.

When you're working on disclosures, you need to think about the litigation and read some of the cases to think about what they've been focused on. When you're talking about proposals to increase share reserves in stock plans, for example, you should think about making a basic disclosure of the number of shares that are currently available for issuance. A number of plaintiffs have been filing claims based on a failure to disclose why there's a need for new shares. So it's good to have an explanation as to why the existing reserve is insufficient and why the company thinks that in the future it's going to need more shares.

It's also good to have some disclosures around the planned use of the existing share reserve and the use of the additional shares, and how long the company expects the new share reserve to last. Some discussion of the methodology or the process used to determine the additional number of shares is helpful when you get into litigation. And it's good to consider some disclosure of the burn rate, and the value transfer and overhang with respect to the stock plan.

Disclosures relating to say-on-pay votes are really where the plaintiffs have been using an M&A-type of attack, going to the court and asking for additional information, mostly underlying the compensation consultant's work and the process going into the compensation that's being voted on. So it's good to describe and summarize the consultant's role and the advice and the recommendations that the consultant is making.

It's also good to think about how you're going to correlate the executive pay and the peer group ranking with the company's performance. In some of the cases, the plaintiffs will complain that a 75% benchmark was used, or about some of the companies that are being followed to come up with that benchmark.

Plaintiffs may claim that management hasn't done as good a job at those companies and may demand more disclosures correlating the performance of those other companies with the performance of the company at issue, which may not be what was actually happening when the company came up with the 75% benchmark. A review of the cases is very helpful there.

Those are some of the things to look at in the disclosures.

As I've said, it helps, once the disclosures have been made, to have somebody track whether or not one of these plaintiffs' firms - and it's probably going to be Faruqi - has put your company on a watch list and sent out a press release announcing an investigation. Once that happens, there's a decent likelihood that you're going to get a complaint. So you need to take steps. At that point, you'll be able to take more concrete steps as to getting litigators involved in thinking about how the litigation is going to unfold and what you can do to prevent that from impacting your vote.

With that, I'm going to hand it off to Mark to talk about some of the say-on-parachute developments.

Say-on-Parachute Litigation

Mark Poerio, *Partner, Paul Hastings LLP:* Thanks, Rick. That was a great way to get us started.

I'm not a litigator, but a corporate adviser. To build on what Rick was saying, I'm reading many of the executive compensation disclosures in proxy statements from the preparation perspective. I have two other things to add to the list in terms of anticipating where litigation could come from.

Certainly, we're under a microscope in what we disclose on executive pay. Two things that I come across with some regularity are disconnects between what's stated in the compensation committee charter or philosophy and what actually gets decided. The other one involves inconsistencies between different years. You should expect that anyone who reads disclosures from a shareholder derivative suit perspective is going to be honing in on any inconsistencies or stumbles you have in making full disclosures.

As we move on to say-on-parachute cases - the second topic in this program and Slide 4 in your materials - I will note that the Dodd-Frank say-on-pay requirement has received most of the press attention and most of the litigation attention, as Rick just described. The say-on-parachute requirement is one that, in some respects, may be in its infancy and developing a little more slowly, because we haven't had as many cases concerning them. But one reason we put this topic as number two is we think there is a lurking litigation risk here, too.

To take a step back, Dodd-Frank requires that SEC-registered companies, when they are selling or merging, make two new disclosures in the say-on-parachute context. One is to make a disclosure through a golden parachute table that highlights any additional compensation and benefits that the named executive officers receive in the transaction.

In addition to the tabular disclosure, the selling company (or the company not surviving a merger) is required to present a proposal as a non-binding advisory vote (similar to the say-on-pay advisory vote), which seems less significant or even insignificant in many cases. That's because everyone expects the transaction will be approved. And even if stockholders vote against the golden parachute amounts that are being paid, those payments nevertheless get made and the transaction closes. So there has been a sense that this vote is more of a formality.

But the *Encore Bancshares* case starts to give us a sense of what could come. Here, within four days after the selling company, Encore, sent out its merger proxy, it was hit with a shareholder derivative lawsuit. In this case, there were M&A litigation-style allegations that the transaction was benefiting the insiders and management, and that the company hadn't made adequate disclosures when it was explaining the process for the transaction unfolding.

What was a little bit different in this context is that the complaint drew heavily from the golden parachute disclosures that appeared in the proxy statement. So I think that, with increased merger-related golden parachute disclosures, we're going to see shareholders studying them and trying to figure out - are there inconsistencies with past 14A disclosures? Is there justification for the golden parachute amounts that are being paid? If the company has extraordinary amounts on the table that might not have been disclosed before, is there a convincing justification? All of these things have the potential for directors and decision-makers to be called on the carpet and questioned about.

If there is a failed say-on-parachute vote, you wouldn't think, based on the failures of say-on-pay litigation, that there would be exposure. Nevertheless, that possibility is out there.

With all this in the mix, smart companies are anticipating the scrutiny and, just as in the Schedule 14A proxy statement proposal process, looking at these say-on-parachute disclosures, being ready for hard questions, and trying to avoid being on the radar screen for litigation.

Joe, Rick, do either of you have something to add?

Corporate Waste Litigation

Joe McLaughlin, *Partner, Simpson Thatcher & Bartlett LLP:* No. But I think this is a good transition to a recent Delaware Court of Chancery decision, in which a judicial determination that a plaintiff was not entitled to attorneys' fees was the platform for a pretty deep judicial dive into the standards of corporate waste as applied to executive compensation. The citation for the case, *Freedman v. Adams,* is on Slide 5 of your materials.

A former stockholder of XTO Energy sought $1 million of attorneys' fees following the stipulated dismissal of her derivative action. So she didn't really win before seeking attorneys' fees. You might well ask - how did that come to pass?

The unique profile of shareholder derivative lawsuits is the answer. As you may recall, a shareholder who seeks to bring a derivative claim - that is, one not on his or her own behalf, but on behalf of the company - has to either make a pre-suit demand on the board to bring the claims, or skip the demand and allege with particularity why demand would have been futile.

Here the plaintiff brought derivative fiduciary duty and waste claims and skipped the demand, challenging the board's approval of bonuses to five executives at XTO Energy over a three-year period. The gravamen of the challenge was that the board had approved these bonuses to five executives without having in place a tax-deductible bonus plan for cash compensation adopted under Section 162(m) of the tax code.

Mark is going to discuss in a moment some of the ins and outs of other Section 162(m) challenges in litigation to stock plan approvals under 162(m). In short, the federal tax code permits cash bonuses to be deductible if they are performance-based and contingent on the executive achieving certain performance goals that are set forth in the statute. The plaintiff here contended that the board structured the award of the bonuses in a way that caused the company to forgo about $75 million in tax deductions, which is no small lump of change.

After the suit was filed, the board reversed course and adopted a cash bonus plan that complied with Section 162(m) for tax deductibility. The board submitted the plan to the stockholders, and got approval for it.

That obviously was not great for the plaintiff's claim, from one point of view. She also lost standing by selling her shares via a merger. So she was pretty much extinguished from having any place in court. But she and her counsel nevertheless sought $1 million in attorneys' fees based on something called the corporate benefit doctrine, which allows a plaintiff who brings a claim to argue that her bringing the claim was what motivated the board to take some action that resulted in a benefit to the company. Here the board, she said, was motivated to adopt the cash bonus plan that permitted bonus payments to be tax deductible solely because of her lawsuit.

This claim gave the court the opportunity to dig deep into whether this was waste or not. That's because an essential element of an entitlement to an attorney's fee under the corporate benefit doctrine is to show that your suit was meritorious when filed, which opens up the court looking at the claims.

Here, the court thought it had no reason to look further than the demand futility issue. At first blush, you'd say, "What does that have to do with whether bonuses were properly structured or whether it was waste?" But it actually it has very much to do with it. That's because when a plaintiff is seeking to excuse demand as futile, the plaintiff has to say that there's something about the directors that makes them unable to fairly and impartially consider the claims, or that the challenged transaction - here, the decision about structuring bonuses - was otherwise than the product of a valid exercise of business judgment.

The plaintiff took a run at it from both angles. First, she said that a majority of the nine-person board was unable to impartially consider a demand related to her claims, because of the compensation to the outside directors who comprised a majority of the board. She contended that the five outside directors' annual compensation exceeded what was customary for similarly situated companies. She also tucked into that an argument that this unusually large compensation was a *quid pro quo* for not implementing a tax-deductible bonus plan.

The court said that large numbers, by themselves, are not sufficient to conclude that an outside director, or any director, was unable to consider claims about compensation. Here, the outside director compensation was quite large. It was in the range of $750,000 and more in 2007, for each director, which was up from an already handsome amount in the $500,000 range in 2006. But the court said that it was not enough to show that the compensation exceeded what was customary.

In particular, the court noted - and I think this bears emphasis for future reference - that XTO was a relatively large public company that had outperformed its peers in the S&P 500 and the Dow Jones U.S. Exploration and Production Index. I think practitioners should note that the result arguably could differ for a small private company that underperformed in the market.

The *quid pro quo* argument didn't go anywhere, either. The plaintiff relied heavily on a 10-year-old case that's cited all the time by plaintiffs alleging *quid pro quo*, called *National Auto Credit*, where a Delaware court found that sufficient allegations of a *quid pro quo* between directors and compensation disqualified them from being able to consider claims regarding compensation. However, in *Freeman,* the court said that, unlike in *National Auto Credit,* there were no factual allegations from which you could form a reasonable inference that the increase in the outside directors' compensation was tied to the board's decision not to adopt a tax-deductible plan.

The court then jumped into plaintiff's alternative basis to challenge board impartiality, which was challenging the transaction as a valid exercise of business judgment by alleging that it was corporate waste. It bears emphasis that the plaintiff's waste claim here was unusual. It didn't allege that the amount of the cash bonuses paid to the executives was wasteful *per se*. What she was challenging was the way in which those bonuses were structured, which she said was irrational and resulted in tens of millions of dollars in unnecessary costs to XTO, because they weren't structured in a tax-deductible manner.

The court really gave both barrels to the plaintiff on this issue, saying that none of the claims alleging waste because the bonuses were not set up to be tax-deductible were waste. There is a whole panoply of quotes - if anybody ever wants to show that there is a high standard for a finding of corporate waste in Delaware, this is the case to go to. The court says that waste is an outside boundary of the law that protects against very egregious one-sided deals, in which no business person of ordinary sound judgment would conclude that the corporation had received adequate consideration.

In fact, the court picked up a thread that's been cited in several cases, and which is a very helpful standard when you're defending a compensation decision as not wasteful. If the corporation has received any substantial consideration and the board has made a good-faith judgment that the transaction was worthwhile, it's just not waste, even if it turns out it was a bad deal. So the court basically said that, if anybody in their right mind could conclude that the deal made sense, then that's the end of judicial inquiry.

The court then said - how do you apply this to the actual facts? The court said that decisions regarding a company's tax policy were not well-suited to after-the-fact hindsight-informed review by a court. I would go so far as to say that this is perhaps the quintessential area of corporate decision-making left to the sound business judgment of management, so long as it's exercised without external influences that are not appropriate.

The court, in a very important ruling, rejected the notion that there's a general fiduciary duty to minimize taxes. The court noted, with I think a great deal of good business sense, that a company's tax policy can implicate virtually every decision it makes, including decisions about capital structure, the form of the various entities that the company sets up, what jurisdictions the company forms them in, when to purchase capital goods, whether the company should rent or purchase real property, and so on. A decision could be challenged every day on the basis of failure to maximize tax opportunities, if that were a general component of fiduciary duties. So the court soundly rejected that notion.

I think this decision was, in short, a strong shot in the arm to the notion that the business judgment rule will continue to provide a very high barrier to the success of waste and related claims, absent some particularized facts that really don't pass the smell test, showing that some improper, extraneous influence was afoot.

Finally, I think - and as a good introduction to Mark's comments - it militates in favor of giving very serious consideration to adopting a Section 162(m) bonus plan. It's really not that hard to do, and it can be incorporated into the company's regular stock incentive plan.

With that, I'll turn it back to Mark to address litigation challenging stock plan approvals.

IRC Section 162(m) Litigation

Poerio: Thanks, Joe. As we go to topic four here (Slide 6 in your materials), the two cases, *Seinfeld v. O'Connor* and *Hoch v. Alexander*, are instructive, not just in terms of Internal Revenue Code Section 162(m) litigation risks from stockholders, but also because, in some respects, they exemplify a common tactic that we're seeing when it comes to litigation about executive compensation.

In the first case, *Seinfeld,* the plaintiff shareholders brought what was essentially a new kind of claim. After plaintiffs lost the first case, which we'll talk about in a second, they studied the reason for the failure, and then looked for other proxy statements or plans that were more vulnerable to a claim, based on what the Delaware court held in the first case.

Let's start with the *Seinfeld v. O'Connor* case. These challenges to Section 162(m) stock plan approvals are typically based on disclosures made in the proxy statement. As Joe said, when a company presents a plan for stockholders approval for 162(m) purposes, the company is generally seeking a permissive approach when it comes to discretionary stock awards, so that if it wants to structure awards in a manner that's exempt from 162(m), it has the ability to do so. Rarely, if ever, do you see a plan that mandates that stock awards only be made under conditions exempt from 162 (m).

Interestingly, though, that's the premise for the first claim that came out, in *Seinfeld v. O'Connor*. The plaintiffs said that they inferred from the proxy statement that getting 162(m) approval meant that there would be an assurance that the plan awards were going to be exempt from 162(m) - that it wasn't just a permissive authorization, but a commitment to stockholders in that regard.

The Delaware court dismissed the complaint, saying that the proxy statement was clear that the plan was permissive and enabling, not mandatory.

It was something of a surprise that not that much later - maybe six or seven months later - *Hoch v. Alexander* came out. In that case, the proxy statement was not, on its face, communicating a commitment to make awards that were always going to be 162(m)-exempt. But there was just enough language in the disclosure that the plaintiff was able make an argument that the disclosure would mislead the stockholders into believing that the plan would require 162(m)-exempt awards. The surprise that came from *Hoch v. Alexander* is that it survived the motion to dismiss.

When I read the court decision, I felt as if the court was throwing up its hands in looking at the convoluted Treasury regulations dealing with 162(m) - seeing them as being incredibly complex. The court said it was not going to get into the 162(m) weeds on a motion to dismiss, and that there was enough thrown out by the plaintiff in the complaint to suggest that there was uncertainty in terms of what was being proposed and promised to stockholders.

The real lesson from *Hoch* - not just for 162(m), but for stock plan approvals generally - is that companies that are proposing their plans need to watch the litigation. We're certainly being very careful in every plan that we are proposing to make unambiguously clear, in several places, that the 162(m) part is permissive and enabling, to defuse any risk that you could get into a *Hoch v. Alexander* situation, where a court sees some potential ambiguity on that point.

Looking to our stock plan approvals generally, we make sure that when we are proposing a plan - going back to the points Rick made earlier - we are being exact in terms of the details and the justifications that go with the material terms.

We listed the *Freedman* case under this topic to reiterate its importance for this topic too. My favorite quote from the case was the one that Joe mentioned, essentially, that there is no broadly applicable fiduciary duty to minimize taxes. Section 162(m) is best approached as an enabling, permissive tax play. It shouldn't be a source for future litigation in this respect.

Rick, do you want to take us forward?

SEC Clawback Litigation

Gallagher: Yes, I will. Thanks, Mark.

If you look at the last 10 or 15 years of executive compensation litigation, and listening to you and Joe, it underscores that it's an area that's ripe for litigation. The plaintiffs' bar really wants to get into this area in its different manifestations, but the standards are very difficult. That's really been one of the themes that connects all of these areas - that the legal standards are really tough. As Joe said, the standard for waste is among the highest, if not the highest in governance litigation. And the business judgment rule and the pre-suit demand requirement are also very hard.

Topic number five is SEC clawback litigation - it's Slide 7 in your materials.

I don't think the attack on say-on-pay has legs, going into the next couple of years. I say that based on conversations with members of the plaintiffs' bar who are going to stay away from it. But I think that clawback litigation has the potential to really be a big deal.

Up to now, we've had SEC clawback litigation under Section 304 of Sarbanes-Oxley. That's been an area that's been around now for 10 years. For the first seven or eight years after Sarbanes-Oxley was passed, while it was obviously an important area, it was something of a sideshow, simply because the SEC didn't bring a whole lot of actions. The courts had ruled that there was no private right of action, so private plaintiffs couldn't get involved. So we were left with the small number of cases brought by the SEC.

Cases under Section 304 are limited to the CEO and the CFO, and there has to be misconduct at the company. Where those things occur, and there's been a restatement, the SEC can seek a clawback for 12 months' worth of bonuses, incentive-based compensation or stock sale proceeds from the CEO or CFO. So we have kind of a narrow regime.

For the first six or seven years, the cases were focused on companies where the CEO or CFO had, in fact or allegedly, done something bad. So these weren't really controversial cases, except, obviously, to those involved.

Starting in the last two or three years, the SEC litigation has expanded. The SEC has decided to go after CEOs and CFOs that the SEC hasn't even alleged did anything wrong. I won't get deeply into the couple of cases that are on the slides, because we're running short on time, but they're very good examples.

In the *Baker* case, which was decides a couple of months ago down in Texas, the CEO and the CFO weren't alleged by the SEC to have done a single thing wrong, or even to have known about the misconduct that led up to the restatement. It's a fairly remarkable decision, in that the court goes through an analysis and finds that, even if the CFO or CEO are innocent, did all the right things and had nothing to do with the restatement, they can still have all of their stock or incentive-based or bonus compensation clawed back.

The court went through a number of constitutional arguments and rejected them all. It went through the statute and found that it really didn't matter if the targets hadn't done anything wrong.

Now, I should note that, if you're a CFO or a CEO, or if you're representing one, and you're facing one of these suits, it may depend on where you are. The Ninth Circuit considers clawback claims under Section 304 to be equitable. So in the Ninth Circuit, you're probably not going to face a clawback unless the judge finds that your CEO or your CFO has done something wrong. That's kind of a judicial overlay on the statute.

The other big case that deals with the expansion of the SEC litigation in this area is the *Cohen* case from the Second Circuit. That decision enhances the ominous turn that SEC clawback litigation took recently. The Second Circuit found that, even though the company is the one that is supposed to receive the proceeds from an SEC clawback action, there is no ability by the company to release the clawback claims, such that the CFO or CEO can enter into a global settlement and take comfort that they're not going to face an action.

The Second Circuit said that the SEC is the one that owns these claims, even if the proceeds go somewhere else, and the company can't release these claims. That really inhibits the litigators' ability to deal with these things as part of a global settlement, where you have large civil settlements trying to put things behind the company and its former officers, because you no longer can release - at least under this authority - exposure to the SEC claims. And, of course, that can be tens or hundreds of millions of dollars in liability that the CFO and CEO potentially face.

Now I'll talk for a couple minutes about the other half of clawback litigation, which is upcoming litigation based on the Dodd-Frank clawback rules. There's Section 956, which applies to financial institutions, and Section 954, which applies to all public companies. Section 954 is going to be a really big deal.

We don't have the SEC rules yet. The SEC has been promising them every six months, but nothing has come of them. I read, I think on Broc's blog, the SEC's annual report, in which they stated that they think that they're going to have the rules for Section 954 done this year, and maybe that will be the case. I kind of think it's going to be 2014, but we'll see.

In any event, Section 954 is going to be such a big deal because, like the turn in the SEC litigation, Section 954 is going to require listed companies to have policies that require a clawback effort, not just for the CFO or CEO, but for a number of different officers. And that's yet to be defined.

And, under Section 954, it doesn't matter whether or not there's misconduct. There just needs to be a material misstatement of the financial statements. So there just needs to be a restatement.

The big unanswered question - or at least one of them - is whether or not the private plaintiffs bar is going to have the ability to bring what I believe will be derivative suits, demanding that the board enforce clawbacks.

At least since 1995, there have been 700 to 1,800 public company restatements per year. Going forward, once these rules are in place, every single time a public company restates, they are going to be facing a potential clawback claim, possibly by the private plaintiffs' bar. This is going to be a real mess, and there are a lot of questions that need to be answered.

First of all, does a board have discretion not to do a clawback? Say that, after hiring a law firm and an auditor and a consultant, it is going to cost $5 million to try to claw back compensation following a restatement. If the compensation at issue is only a few million dollars, can a board decide not to do it, because it would be irrational? The statute is unclear, but it may suggest that the board doesn't have discretion, and that the clawback must proceed.

What if compensation agreements with officers and executives don't have contractual mechanisms for clawing back compensation, because the lookback is three years? How would a company go about in a case like that even enforcing the clawback?

There are a host of definitional issues, which I don't have time to get into in detail. What's going to count as the compensation that's at issue? What is going to qualify as incentive-based compensation? How much of the compensation is going to be subject to clawback as a result of the restatement? And what if a company grants incentive-based compensation that wasn't based on metrics that were restated, or arguably weren't?

Companies are going need a lot of professional help in determining whether to go forward with a clawback, and the amounts may not even be very big. On top of that, if courts rule that there is a private right of action, as I said, every time you have a restatement, you're going to have the private plaintiffs' bar alleging that, not only did the board screw up the financials or allow that to happen, but they now must initiate a clawback proceeding to get the compensation.

As you can imagine, it could be a pretty flammable set of circumstances. And I think that, if there is a private right of action, this is going to be a pretty big deal.

Now I'll hand it back to Mark to talk about director compensation litigation.

Director Compensation Litigation

Poerio: One reason we included director compensation in this program is that just last year, roughly six months ago, you had *Seinfeld v. Slager* come out of Delaware. That was a lengthy decision that went into many different executive compensation-related claims involving waste, excessive compensation, etc. and knocked all of the claims out, except for one. That was the one that made us want to mention this topic - the allegations that a board had paid itself very high fees.

The defense that the company put forward in the case essentially drew from the second bulleted case that we noted on Slide 8, which is *3Com*. In the *3Com* case, there was a stock plan, and it involved stockholder approval for annual director stock awards. When the stock awards to directors were challenged, the court applied business judgment rule concepts, finding that stockholders had actually, through the plan, approved what the court described as a "meaningful limit" on director compensation. As a result, since the stockholders had blessed the stock awards to the directors, the directors could - when they followed through on those awards - have their decision be reviewed under business judgment rule principles, rather than what's called entire fairness, which applies in a situation where board members are otherwise acting under a conflict of interest.

In the *Seinfeld v. Slager* case, one of the arguments that the company used to try to defend its director compensation was that stockholders had approved an omnibus stock plan that had a maximum limit on all stock awards to all eligible parties. Since directors were one of the eligible parties, the company argued, the stockholders had essentially approved whatever awards directors received under the plan.

In the *Seinfeld* case, the court said that the plan's overall share reserve limit really wasn't a meaningful limit on per-director compensation, because it was so high. If that were the case, the court said, the directors could have been awarding themselves multi-million-dollar annual awards.

As a result, the court did not dismiss the one particular claim on director compensation, and instead said that it was going to be remanded for review under an entire fairness analysis. That puts the company in the position of having to defend the award, both in terms of the process that was followed - such as, did they have peer group analysis to decide what's appropriate? - as well as the substance - was the ultimate decision a reasonable one and fair to stockholders, or was excessive compensation involved?

I think there are two takeaways from the *Seinfeld v. Slager* case that are worth noting. The first one involves being aware that this case is there. Certainly any boards that are looking at increasing their compensation ought to be building a good, solid record, and being certain that they've looked at the competitors and have put together a program that's reasonable and justifiable.

A second possible outcome - and I'm really intrigued to see if this becomes common - involves a new stock plan which you're putting up for a stockholder vote. Could it make sense to include a meaningful limit on director compensation, whether it's expressed in dollars or shares?

Just to give a simple example - suppose directors currently make X dollars. A plan could say stockholders approved payments of X plus 50%, because that would give room for increases, and arguably would qualify as a "meaningful limit" (within the meaning of the *3Com* case) because it's not something that would go from being hundreds of thousands of dollars of director compensation to millions.

It remains to be seen if that becomes a strategy that companies take to defuse this type of claim. But certainly being heads-up about director compensation is a good takeaway from this case.

Joe, do you want to comment on this and then bring us home?

Conclusion

McLaughlin: This has been a very helpful and robust discussion - for me, at least. I think it has - in a very crisp fashion - walked us through what has really been the attempt by certain members of the plaintiffs' bar to try to tap into populist sentiment fueled by frustration with a prolonged economic downturn and turn that in a direction towards what they would perceive to be overcompensated executives in that context.

It's pretty clear that careful compensation decisions require more input from lawyers than ever before. And it's pretty clear that a well-advised compensation committee and board will benefit greatly from an interdisciplinary approach reflecting input from both corporate lawyers and litigators.

Just to round out the discussion about these lawsuits by plaintiffs to enjoin shareholder votes regarding the approval of an executive compensation plan - note that, as many of these cases evolve, they do get better. Now these cases are being brought as class actions, instead of derivative lawsuits, which allow the plaintiffs to avoid the pleading barrier of demand futility, which was an obstacle, as we've seen, to proceeding with many of the earlier lawsuits.

I think companies are going to have to decide whether they take a principled stand and say, "Our disclosures are strong and we can resist this attempt to enjoin the deal," against the obviously daunting prospect of an injunction against your shareholder meeting, which is a very big deal.

I would also note that, in my judgment, it's unlikely that changes in companies' proxy statement disclosures are going to deter plaintiff firms from instituting these kinds of claims for injunctive relief. But it should be self-evident that good, strong, adequate disclosures will strengthen the ability of a company to succeed in opposing a motion for a preliminary injunction, should it come.

Obviously, companies and their boards should remain very diligent in ensuring that they have adequate disclosures in their proxy statements concerning executive compensation proposals. It really would be a perverse result - and one that was actually against the interests of the stockholders that these plaintiffs purport to represent - if the plaintiffs' bar, through these litigation efforts, created an incentive for companies to hold back certain disclosures as a possible way to settle them. That has been the end game for many or all of these lawsuits. It's worth noting that, so far, these claims have not produced any money for the company or the investors or even changes in executive compensation.

Without making too strong a political statement, I think it's really been the plaintiff firms that have been the main financial beneficiaries of these lawsuits. I talked about the corporate benefit doctrine earlier. Once a case has been settled, the plaintiff firms, under the corporate benefit doctrine, are able to argue that they have provided a benefit to shareholders by giving them the information needed to make investment decisions.

I would sum up by saying that advisers to companies should ensure that compensation decisions are properly informed with an adequate document or record to support a determination that decisions were made in good faith and that your disclosures are as strong as they reasonably can be.

Romanek: Thanks to Rick, Mark, and Joe. It was a terrific program. Hopefully we'll continue to see developments that are positive. But for sure, there will be more developments, and we might have to reprise this program before we know it. Thanks very much.