New Form of Say-on-Pay Litigation Appears

In recent months, a new form of Say-on-Pay lawsuit has appeared. These suits, which are filed as "class actions" after a company has filed and disseminated the definitive proxy materials for its annual meeting of shareholders, seek to enjoin the company from conducting its scheduled shareholder advisory vote on the compensation of its named executive officers (a "Say-on-Pay" vote), claiming that the company's directors have breached their fiduciary duty by recommending that the Say-on-Pay proposal be approved on the basis of incomplete and misleading disclosure about the company's executive compensation program. Modeled on suits in the mergers and acquisitions area (which seek to enjoin a merger vote on the basis of inadequate disclosure), these actions first appeared in January 2012 in connection with annual meetings where approval of an employee stock plan (or approval of a share reserve increase for an existing plan) was scheduled for shareholder action; alleging inadequate disclosure.

While a few companies have been successful in getting courts to deny the request for an injunction, the risk of such lawsuits has not decreased. Consequently, companies must be aware of the threat that they pose and be prepared, if necessary, to defend a suit to avoid having it impact their annual meeting.

Alleged Disclosure Deficiencies for Say-on-Pay Vote

To date, nearly 30 of these lawsuits have been either announced or filed (nearly half of which involve technology and life sciences companies). While the allegations concerning the inadequacy of the disclosure relating to the Say-on-Pay proposal have varied from company to company, typically they seek additional information on matters such as the following:

- The criteria for selecting the compensation peer group used by the compensation committee to target the company's executive compensation, as well as a summary of the executive compensation data for this peer group;
- How the compensation committee set the target pay positioning for the company's executive officers;
- 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 the target annual incentive award opportunities of the company's executive officers; and
- How the compensation committee selected its compensation adviser, a summary of the advice, counsel, and analyses performed by this adviser, and the other consulting and business services, if any, that this adviser provided to the company's management.

In the case of an employee stock plan proposal, the plaintiffs have sought additional information on 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.

What's Really Going On

It's apparent that the timing of these lawsuits is deliberately designed to put the targeted companies in an untenable position – defending their executive compensation disclosure (whether or not there's any merit to the plaintiff's allegations) once the countdown to the annual meeting of shareholders has commenced. Clearly, the plaintiff is hoping to extract a quick settlement (and attorneys' fees) from a company seeking to avoid a delay to its annual meeting or having to hold the meeting open with respect to the Say-on-Pay proposal until the lawsuit is resolved. To date, a handful of these lawsuits have been settled, with attorneys' fees in the low six figures being paid.

Typically, these lawsuits are being filed in state court in the jurisdiction where the company has its principal place of business, rather than, in most instances, in the state where the company is incorporated (usually Delaware). In addition, the lawsuits – or investigations that may lead to a lawsuit – are being filed (or announced) almost immediately upon the filing and dissemination of the proxy materials for the annual meeting of shareholders. To give you an idea of how what is happening here, at least one such lawsuit was filed on a Tuesday with respect of a proxy statement that was filed with the SEC on the previous day.

Can You Protect Yourself from These Lawsuits?

As with any potential legal matter, you should consult your company's legal counsel to obtain their views on these lawsuits and determine how best to prepare for the possibility of such a suit.

At the moment, it's unclear whether a company can insulate itself from this type of lawsuit (or even reduce the risk of such a lawsuit) by enhancing its disclosure - principally its Compensation Discussion and Analysis. Given that the CD&A must contain all of the information that the company considers material to an understanding of its executive compensation program, policies, and decisions, it's presumed that this disclosure is complete when the proxy statement is filed. Essentially, these lawsuits are second-guessing that presumption.

Ultimately, it's the company's decision, within the framework of Item 402 of Regulation S-K and the related SEC Staff interpretations, to determine the material information that it must disclose. And while these lawsuits are putting that decision to the test, that's not the point here. The plaintiff isn't seeking to establish that a company's disclosure is sub-standard; they're looking to pressure the company into a quick settlement (and the attendant attorneys' fees). Consequently, there is little you can do other than to be vigilant in the event that you become the target of such a suit.

Need Assistance?

Compensia has had significant experience in helping companies to draft the executive compensation disclosure in their proxy materials. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance, please feel free to contact Mark Borges at 415.462.2995 or mborges@compensia.com. ■

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