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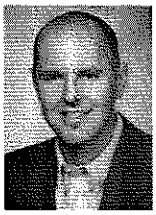

# U.S. Executive Compensation Litigation: Cannons to the Right ... and to the Left

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***As we start 2013, the volley and thunder of executive compensation litigation comes from several directions. Shareholder derivative litigation in the United States continues to take aim with claims ranging from excessive pay to the approval process for stock plans – with the most recent nuisance tactic being to delay annual meetings. The fighting gets more personal when individual awards are involved, most often because the claims come from former executives. And then there is the government: from legislation to regulation, there is pressure on boards of directors to make executive compensation more long-term and performance-based.***

***In this valley of risk, corporate boards will be smart to look to 2012 litigation developments in order to best manage their executive compensation structures and award practices. The following checklist recaps those developments.***

## Shareholder Derivative Litigation

- Beware of Injunctions Aimed at Delaying Annual Meetings. For shareholders unhappy with executive compensation, last year started with claims against companies that failed to obtain majority support for their "say on pay" votes. After a series of U.S. court decisions dismissed those so-called "failed say on pay" cases, a new tactic emerged in the form of allegations that proxy statements omitted material disclosures, thereby purportedly preventing shareholders from making informed "say on pay" votes. These actions sought injunctive relief to delay the annual meeting of shareholders. There are a few reports of settlements of these cases involving payment of hundreds of thousands of dollars for attorneys'

fees, but courts have recently been dismissing these actions.[1]

- Director Compensation. Whenever new or amended stock plans are being submitted for shareholder approval, corporate boards should consider including a plan provision that imposes a maximum limit on annual director compensation. Under established case law in Delaware, the leading state for incorporation of large companies in the U.S., a meaningful limit on total compensation will enable directors to benefit from business judgment rule protection if shareholders claim that director self-interest has resulted in excessive compensation. (See, for example, *In re 3Com Corp. Shareholders Litigation*[2].)

  In 2012, a Delaware court applied this analysis to a claim that directors had awarded themselves stock awards and total compensation far in excess of peer levels. The litigation survived dismissal mainly because the court found, in *Seinfeld v. Slager*,[3] that a stock plan's maximum limit on all stock awards was so high as to give directors too much discretion to allow for judicial review under the *3Com* standard. Absent such business judgment rule protection, the court held that directors must prove in subsequent proceedings that their compensation meets an "entire fairness" standard. In view of the *Seinfeld v. Slager* decision, corporate boards would be wise to develop a comprehensive record by which to demonstrate reasonable compensation, and to consider seeking shareholder approval for a meaningful limit on their future compensation.

- Misleading Proxy Statements. The demands for comprehensive executive compensation disclosures have led to litigation alleging breaches of fiduciary duty ranging from pay not correlating to performance (despite a board's professed "pay-for-performance" philosophy),[4] and stock plan proposals that misled shareholders about the tax consequences of awards. The latter claim survived a motion to dismiss in *Hoch v. Alexander*, in which a Delaware court found open questions about "whether certain treasury regulations [under Internal Revenue Code §162(m), which generally precludes a deduction by publicly held corporations of certain compensation paid to high level employees in excess of USD1,000,000] apply as

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[1] See *Noble v. AAR Corp.* (Case #1:2012cv07973, N.D. IL), and *Gordon v. Symantec*, Case 1-12-CV-231541 (CA Sup. Ct).

[2] *In re 3Com Corp. Shareholders Litigation*, No. CA. 16721, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999).

[3] *Seinfeld v. Slager*, C.A. No. 6462-VCG, 2012 WL 2501105 (Del. Ch. June 29, 2012); compare *In re 3Com Corp. Shareholders Litigation*, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999) (finding "meaningful" plan limits on stock awards to directors); see also, *Valeant Pharmaceuticals Int'l v. Jerney*, 921 A.2d 732 (Del. Ch. 2007) (applying entire fairness test to directors' bonus compensation); and J Robert Brown, "Returning Fairness to Executive Compensation" (2008) 84(4) *North Dakota Law Review* 1141.

[4] See, *e.g.*, *Haberland v. Bulkeley*, CF.Supp.2dC, No. 5:11-cv-463-D, 2012 WL 4788442, *8 (September 26, 2012) (dismissing a wide variety of claims premised on allegations of excessive compensation).

well as the meaning of the Proxy Statement."[5] This has spurred numerous similar cases but no further shareholder successes.

## Claims by Former Employees

- Valuation Disputes. When private employers sponsor stock award plans, valuation becomes a common source both for tax issues and for disputes with award recipients. In *Fried v. Stiefel Labs*,[6] a court in the federal court for the Southern District of Florida examined and denied an employer's motion to dismiss securities fraud and fiduciary breach claims against the controlling shareholders of a privately-held corporation. In particular, a defendant who was also an insider of the company had allegedly made misleading statements to former employees (who received stock plan awards and were thus also minority shareholders) about the valuation of the company's stock, including misrepresentations and/or omissions of material information relating to both a recent capital raising transaction and the valuation of the company's stock received during that process. The former employees claimed that this led them to sell their stock at a price significantly lower than its actual value (as determined in connection with a sale of the company that was announced soon after the former employees sold their stock).

  With respect to impending major corporate events, while there is generally no duty of disclosure while discussions remain ongoing, the *Stiefel Labs* case highlights the risk of disclosure-based claims if a corporate defendant or controlling shareholders make selective, misleading, or deceptive disclosures relevant to stock value.[7]

- Expired Stock Options. Stock award litigation frequently arises when current or former employees attempt to exercise options that have expired according to the terms of the underlying plan or award agreements. In these cases, former employees typically argue that the employer failed to provide advance notice of the impending expiration, or that the employee was unable to exercise the options due to employer-caused restrictions.

  In *Rawat v. Navistar*,[8] former employees alleged breach of contract and breach of the covenant of good faith and fair dealing, because their options expired during a "blackout" period during which employee stock transactions could not occur, caused by a financial restatement. The employer defended arguing that the general release of claims executed by these employees upon their termination of employment prohibited them from asserting a claim. However, the federal district court disagreed, holding that because the 90-day exercise period following

[5] *Hoch v. Alexander*, case #1:2011cv00217, D.De (2011).

[6] *Fried v. Stieffel Labs*, 2012 WL 4364300 (S.D.Fla. 2012).

[7] Ibid 4, citing *In re Miller Indus. Sec. Litig.*, 120 F.Supp.2d 1371, 1378 (N.D.Ga.2000) (*quoting First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir.1977)) (noting "[w]here a defendant does make voluntary statements, it must speak completely to avoid 'half-truths.'").

[8] *Rawat v. Navistar Int'l Corp.*, No. 08 C 4305, 2011 WL 3876957 (N.D. Ill. Sept. 1, 2011).

termination ended after the execution of the release, the release was ineffective with respect to the employees' claim.

In *Bank of America v. Emert*,[9] the employer faced a former employee seeking to exercise expired options. After denying the employee's claims pursuant to procedures established under the relevant plans, the employer took the proactive step of seeking a declaratory judgment by a court to establish that the employee was not entitled to exercise the expired options. Although the employer informed the employee of the 90-day post-termination exercise period through issuance of an employee handbook and information posted to an intranet site, the employee argued that the employer breached its duty of good faith and fair dealing by not informing the employee again of the 90-day period upon actual termination. The federal district court, applying Delaware law, held that the employer provided ample notice of the express terms of the stock options, including the 90-day period, and granted the employer's motion for summary judgment.

Both *Navistar* and *Emert* highlight the importance of thorough plan drafting and of proactively warning award holders about material award terms. *Navistar* could have avoided litigation if its underlying plan had contained a provision extending the 90-day period in the event that such period ends during a trading "blackout" period. Additionally, in *Emert*, the court held in favor of the employer because, in part, the 90-day exercise period was disclosed in an employee handbook. An employer could further protect itself from similar claims by establishing a routine procedure for the delivery of a plan document or plan prospectus to any award holder whose employment terminates.

- Dispute Resolution. A decision by the federal appeals court for the 8th Circuit in *Schaffart v. ONEOK*[10] provides a healthy reminder that, in contract interpretation disputes between employers and executives, courts generally enforce applicable contract or plan provisions according to their terms, subject to resolving ambiguities against the employers – as drafters of the documents. In *Schaffart,* the performance and stock plan agreements at issue did not define certain key terms for purposes of determining whether plan forfeiture provisions were triggered. Further, the employer representative who made the key plan decisions was not the person identified in the plan documents to do so, thereby undermining the employer's ability to obtain a deferential standard of judicial review.[11] Overall, these procedural stumbles led the court to resolve close contract interpretation

[9] *Bank of America Corp. v. Emert*, No. 09 Civ. 4561(LTS)(MHD), 2010 WL 2595087 (S.D.N.Y. June 28, 2010); see also *Porkert v. Chevron Corp.*, No. 10-1384, 2012 WL 90142 (4th Cir. January 12, 2012) (rejecting former employee's argument that possible employment agreement contained contrary terms and holding subsequent award agreements clearly indicated options were only exercisable within 90 days following termination of employment).

[10] *Schaffart v. ONEOK*, 686 F.3d 461 (8th Cir. 2012).

[11] See ibid, 471.

issues in favor of the executive, and to award relief.

- Tax Code §409A Amendments. Although the tax penalties fall directly on employees, it is standard in the U.S. for employers to lead efforts to conform plans, awards, and employment-related agreements with the U.S. deferred compensation tax laws established under International Revenue Code §409A. Unfortunately, and as noted above, U.S. courts will generally interpret ambiguities against the drafter. This cost one company nearly $500,000 when its 409A amendment to Restricted Stock Unit (RSU) agreements imposed a required six-month delay in cash-outs but did not specify the valuation date when the equity-based RSUs would be converted to cash.[12]

## Governmentally-inspired

- Mandatory Deferrals. Settlements with U.S. government agencies, particularly the U.S. Department of Justice (DOJ), are increasingly requiring alterations to compensation programs. In July 2012, the DOJ announced a settlement with GlaxoSmithKline LLC (GSK) in connection with its investigation into GSK's alleged fraudulent activities and drug safety reporting violations. This settlement included GSK's agreement to establish both a formal recoupment ("clawback") program and a deferred compensation program under which certain executives must defer 10% to 25% of their annual bonuses for a three-year period. The deferral of bonuses extends beyond termination of employment and all bonuses are subject to forfeiture.[13]

  Similarly, HSBC Bank recently entered into a Deferred Prosecution Agreement with the U.S. DOJ as a result of an investigation into HSBC's connection to drug cartel money laundering activities. With respect to compensation practices, the DOJ agreement requires that the annual bonuses paid to certain senior executives be deferred during a five-year period.[14]

- No-Fault Clawbacks. Section 304 of the Sarbanes-Oxley Act ("SOX") requires the forfeiture and clawback of incentive compensation previously paid to a CEO or CFO if an accounting restatement is required due to misconduct. Until recently, SOX Section 304 claims were only being brought against CEOs or CFOs who themselves participated in or were aware of the misconduct leading to the restatement. However, the U.S. Securities and Exchange Commission (SEC) has recently expanded its application of SOX Section 304 by bringing claims against CEOs and CFOs who were unaware of any misconduct. Additionally, courts have rejected settlement agreements pursuant to which executives are

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[12] *Graphic Packaging v. Humphrey*, 2010 U.S. App. LEXIS 23718 (11th Cir. 11/2010).

[13] *Corporate Integrity Agreement*, <https://oig.hhs.gov/fraud/cia/agreements/GlaxoSmithKline_LLC_06282012.pdf> (viewed on 27 February 2013).

[14] *See Statement of Facts, Deferred Prosecution Agreement*, 30, <http://www.theglobeandmail.com/incoming/article6209613.ece/BINARY/HSBC.pdf> (viewed on 27 February 2013); and *DOL Announcement, 11 December 2012*, <http://www.justice.gov/opa/pr/2012/December/12-crm-1478.html> (viewed on viewed on 27 February 2013).

indemnified by an issuer of securities for SOX Section 304 liability.

In *SEC v. Baker*, the issuer's financial statements were restated due to fraudulent activities by two vice presidents.[15] In the underlying SEC complaint, the CEO and CFO were not alleged to have participated in any of the wrongdoing. However, the SEC nonetheless brought action against the CEO and CFO under SOX Section 304. Interpreting the text of the statute, the District Court held that SOX Section 304 does not require wrongdoing by the issuer's CEO and CFO. As a result, the SEC asserted that their incentive compensation was subject to clawback under SOX Section 304.

In *Cohen v. Baker*, the DOJ objected to a settlement agreement pursuant to which the issuer of the securities agreed to indemnify the CEO and CFO for any losses incurred as a result of SOX Section 304.[16] The Second Circuit considered the underlying purpose of SOX Section 304, and held that any indemnification for SOX Section 304 is inconsistent with Congressional intent and, thus, is void.

## Conclusion

Although the foregoing suggests that the executive compensation may be triggering higher levels of US litigation risk for a variety of reasons, corporate decision-makers might find comfort in two lines of defense. First, an employer could take the initiative and regularly monitor emerging threats in this area. Types of challenges to executive compensation tend to come in waves, and to fall hardest on those who are last to respond to the trends. Those who actively pursue "best practices" in executive compensation generally avoid litigation, or are more likely to win litigation at an early stage. Second, an employer should develop good processes with respect to records and documents. Attention to diligent procedures can provide the best insulation from fiduciary breach claims, with clear and well-communicated plans and awards often being effective against award holders making claims involving interpretation. Overall, an ounce of prevention will best silence the litigation cannons.

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[15] *SEC v. Baker*, No. A-12-CA-285-SS, 2012 WL 5499497 (W.D. Tex. Nov. 13, 2012).

[16] *Cohen v. Viray*, 622 F.3d 188 (2nd Cir. 2010).