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# Analysis

## Executive Compensation

### Shareholder Derivative Litigation Concerning Exec. Comp. Increasing; Corporations Should Review Policies and Disclosures

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With the investment of billions of taxpayer dollars in private institutions in the last year, executive compensation is squarely in the public eye. This scrutiny largely stems from the widely-held perception that compensation pay practices contributed to the financial crisis. Not surprisingly, we have seen a flurry of derivative litigation demands by shareholders regarding executive compensation practices. Publicly traded companies should be aware of this trend and consider taking this opportunity to review their current executive compensation policies and disclosures.

#### Shareholder Derivative Litigation

Derivative litigation permits a shareholder who seeks to challenge a corporate practice to bring suit on behalf of the corporation on the theory that the practice is harmful to the corporation. Typically, the plaintiff in a derivative lawsuit will name as defendants the officers and/or directors involved in executing or supervising the allegedly harmful practice. Derivative lawsuits are one of the few tools by which a shareholder can attempt to second guess management's and the board's business judgment.

Most jurisdictions impose stringent procedural requirements on a shareholder's ability to initiate derivative lawsuits. Many states require

that, before filing suit, the shareholder make a demand on the corporation's board of directors to remedy the allegedly harmful practice. The "demand requirement" exists to preserve the primacy of board decision-making regarding corporate governance and legal claims belonging to the corporation.

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There are certain procedural courses of action to consider in response to a derivative demand. One option may be to summarily reject the demand and defend the shareholder lawsuit if and when it is filed. Another option is to have a majority of independent board members, or a special independent committee of the board, commence an investigation into the allegations to determine whether it would be in the best interests of the corporation to bring an action on behalf of the corporation against the alleged individual offenders.

Generally, in such circumstances, independent board members or special independent committees are vested with full authority to investigate and act on behalf of the company, which allows the company to

retain control over whether the putative shareholder's derivative allegations proceed. Courts in some jurisdictions show deference to such committees' findings.

If a decision is made that the lawsuit should not go forward, either in whole or in part, the corporation may have the burden of proving the independence and good faith of the group making the determination and the reasonableness of the investigation. If, on the other hand, the independent directors decide that claims should be pursued, the corporation can pursue them directly or it can defer to the shareholder to file suit.

Shareholder demand letters challenging executive compensation practices have proliferated of late, which indicates the intent of plaintiffs' counsel to initiate derivative litigation in the executive compensation arena. Such demands have resulted in several companies undertaking investigations of specified aspects of their compensation programs.

#### Typical Demands

Most demand letters questioning compensation practices seek both financial relief for the corporation and a change in the corporation's executive compensation practices.

These letters commonly allege "unjust enrichment" in the sense that certain executives received excessive incentive compensation, notwithstanding the poor financial performance of the company. Other common allegations accuse executives of manipulating or concealing the company's actual performance to maximize incentive compensation payouts. Some allegations are based on "waste of corporate assets" and breach of fiduciary duties to the corporation. The plaintiffs generally demand that the individuals return the purportedly unjust compensation and

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that the company take action against the individuals.

In addition, the demands frequently call for the board to overhaul the company's executive compensation program by including practices that the shareholder believes more accurately link pay to corporate and individual performance. Some demands seek a multi-year vesting requirement, coupled with a "tail" designed to account for the time horizon of risks associated with the performance.

For example, such an award would be forfeited if the performance resulting in a payout is not sustained for a designated period. Moreover, the letters regularly demand that the corporation provide for an advisory or non-binding "say-on-pay" annual referendum that would provide the corporation's shareholders an opportunity to vote on the compensation paid to executives. The demands also frequently seek a commitment from the corporation that no further incentive-based compensation will be disbursed until the allegations are resolved.

## Responding to a Demand Letter

The manner in which a board may decide to respond to a shareholder derivative demand can vary greatly depending on, among other things, applicable state law, the claims asserted, the status of the shareholder making the demand, company-specific considerations, such as approach to litigation and culture, and various other unique facts and circumstances. Notwithstanding these factors, there are certain steps and practices a board should consider upon receipt of a shareholder derivative demand, including:

- convening, in person or otherwise, to review the allegations and determine whether to formally investigate the alleged misconduct and claims;
- deciding whether to appoint an independent special committee to conduct the investigation, if an investigation is deemed appropriate;
- evaluating whether to engage independent outside counsel to assist and advise the board or special committee in any investigation;
- preserving potentially relevant data and information, including in both electronic and hard-copy form;

- notifying the company's D&O insurance carriers of the demand and potential claims; and

- adopting a consistent policy regarding corporate disclosure of the demand.

In all cases, because the independent board members have the decision-making authority to determine whether to commence an action on behalf of the corporation in the first instance, directors should refrain from passing judgment on the merits of the allegations at the outset.

## Best Practices

Staying abreast of evolving executive compensation "best practices" is advisable for companies attempting to deter lawsuits. On June 10, 2009, the Secretary of the Treasury laid out five broad-based "principles" for all U.S. public companies, which are expected to evolve over time with the help of industry and expert advice. These principles attempt to develop standards that reward innovation and prudent risk-taking without creating misaligned incentives. A summary of Secretary Timothy Geithner's five principles and explanatory remarks is set out below.<sup>1</sup>

**1. Compensation plans should properly measure and reward performance.** Incentive-based pay can be undermined if the performance bar is set too low or if bonuses are paid even when a firm's performance is subpar relative to its peers. To reward long-term value creation, performance-based pay should be conditioned on a wide range of internal and external metrics, not just stock price.

**2. Compensation should be structured to account for the time horizon of risks.** Asking executives to hold their equity for a longer period of time may be an effective means of discouraging executives from taking large risks to obtain short term gains.

**3. Compensation practices should be aligned with sound risk management.** Compensation committees should conduct and publish risk assessments of pay packages to ensure that they do not encourage imprudent risk-taking. Firms should consider how to provide risk managers with the tools and authority to manage the relationship between incentives and risk-taking.

**4. Companies should reexamine whether golden parachutes and supple-**

**mental retirement packages align the interests of executives and shareholders.** Companies should review and determine whether such arrangements may have outlived their original purpose and whether they enhance the long-term value of the company.

**5. Companies should promote transparency and accountability in the process of setting compensation.** Companies should ensure that compensation committees are fully independent and that disclosures are more transparent in explaining compensation packages. Companies should disclose the total "walkaway" pay due to executives, including severance, pension, and deferred compensation.

Secretary Geithner's remarks made clear that Treasury is not setting forth precise prescriptions for how companies should set compensation, which he said can often be counterproductive. Instead, Treasury will encourage experts in the field—academicians, business leaders, and shareholders—to conduct their own reviews to identify best practices and emerging positive and negative trends and call attention to risks that might otherwise go unseen.

In implementing the broad principles outlined by Treasury in a compensation program, the following specific practices appear to be favored by many U.S. public companies (some of which will be legally mandated by 2010):

- Inclusion of a non-binding annual shareholder vote on the compensation of executives, as described in the company's proxy statement under Securities and Exchange Commission disclosure rules, including the compensation discussion and analysis and related compensation tables. This so called say-on-pay vote is widely expected to be refined and legally mandated by legislation in 2010, if not in time for the upcoming proxy season.

- Implementation of a "hold-until-retirement" policy for shares underlying equity awards. Such a policy is intended to align equity incentives with the time horizon of risk.

- Use of identifiable performance goals for incentive compensation programs and limitation of discretionary bonus grants when performance goals are not met.

- Use of multi-year vesting periods for at least a portion of incentive awards.

<sup>1</sup> The full text of the remarks can be found at <http://www.ustreas.gov/press/releases/tg163.htm>.

■ Adoption of a compensation recovery, or “clawback,” policy for incentive compensation paid based on inaccurate financial metrics.

■ Placement of a cap on incentive payouts, even if performance exceeds the maximum level identified in the incentive program.

Regardless of the compensation program and practices adopted by a particular company, the most important considerations are: (1) a deliberate and well-documented process in structuring the company’s compensation program; and (2) clear and complete disclosure of the compensation program and decisions made in connection therewith, primarily in the annual proxy statement.

The type or amount of compensation appropriate for one company might not be appropriate for another. Compensation committees, therefore, should focus on engaging in a deliberative process and providing thorough disclosure to shareholders (in particular, disclosure related to those items that receive enhanced shareholder and media scrutiny, such as performance awards, perquisites, and

severance payments). A company’s disclosure is a public record of its compensation policies and processes. Disclosure, therefore, should always be thorough and accurate.

Compensation committees should document meetings, including discussions regarding the compensation program, and approve compensation levels for executive officers at least annually. Additionally, an independent consultant can provide assistance by, among other things:

■ assessing the company’s compensation philosophy and program in light of market practices, evolving best practices, and comparative peer data;

■ working independently of management to develop analyses of and recommendations for CEO pay;

■ reviewing any significant executive employment or severance agreements in advance of being presented to the committee for approval;

■ assisting with a company’s risk analysis (as described below) and identifying areas for improvement; and

■ reviewing the committee’s charter and recommending potential changes.

Finally, SEC rules, as currently proposed, would require all U.S. public companies to conduct an annual risk assessment of the company’s pay programs to determine whether and, if so, how, they might have a material effect on the company’s risk profile. The working group, including the compensation committee and the company’s risk officers, should assess items of the compensation program, such as the selection of performance metrics and the length and balance of performance periods, to determine whether they encourage appropriate or unreasonable risks.

The risk assessment should be discussed in the annual proxy statement. This discussion will demonstrate to shareholders that the board has “done its homework” to assure that the company’s incentive program is reasonably aligned with the company’s risk profile.