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CORPORATE COUNSEL

Trends and Developments in Annual Meeting Proxy Litigation

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The 2013 proxy season appears poised to mark an inflection point in recent trends related to annual meeting proxy litigation. Last year's proxy season saw more than two dozen lawsuits filed or threatened alleging inadequate disclosure in annual meeting proxy statements.

Two types of shareholder proposals served as the basis for the overwhelming majority of such claims: advisory say-on-pay proposals and proposals for the approval of equity incentive plans. Following a successful bid in Knee v. Brocade Communications Systems, Inc. to enjoin Brocade's April 2012 annual meeting, several high-profile companies were served with similar lawsuits, and Martha Stewart Living Omnimedia Inc., WebMD Health Corp., and H&R Block were reported to have entered into settlements to avoid the threat of injunction and the potential cost and disruption of rescheduling their annual meetings.

The number of reported cases actually understates the size of the litigation wave. In a number of instances, companies have been contacted confidentially regarding a request for settlement, while in others a demand is preceded by the press release of an investigation of the company's disclosures. The lead role of law firm Faruqi & Faruqi in launching such investigations and

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representing serial plaintiffs such as Natalie Gordon, who was the plaintiff in cases filed against Microsoft, Cisco Systems, and Symantec, have led numerous practitioners to refer to these claims as a "business model," and the defendants in one action to describe the lawsuit as a "hold-up."

Although 2013 has seen a number of important court victories by defendant companies, investigation announcements by Faruqi & Faruqi and a March 11, 2013, publication under the title "Emerging Trends in Say-on-Pay Disclosure" on the firm's website attacking the "current dismissive attitude regarding the say-on-pay vote due to its advisory nature" indicate that the plaintiffs' bar is likely to continue to bring claims where they identify an opportunity to do so.

Legal Developments

The defense of annual meeting proxy litigation has been substantially assisted by defendants who have prosecuted their cases past the initial request for preliminary injunction. In Gordon v. Symantec Corporation, Symantec successfully defeated a motion to enjoin its 2012 annual meeting based on inadequate disclosure related to its say-on-pay proposal. The ruling on preliminary injunction was particularly significant because it was made by the same Santa Clara County Superior Court judge who had earlier granted the injunction in Brocade.

On February 21, 2013, the court ruled on the merits of Symantec's demurrer and reached two conclusions likely to have a significant impact on proxy litigation: First, the court ruled that once the say-on-pay vote had taken place, "there is no longer any direct disclosure claim available to the Symantec shareholders." In other words, should plaintiffs fail to enjoin a shareholder vote, once the vote has taken place, plaintiffs would need to pursue their claim as a derivative action as the alleged damages run to the company and not directly to the shareholders.

Second, the court ruled that the plaintiff, "fail[ed] to adequately plead a sufficient disclosure claim." In reaching this conclusion, the court cited the holding of Kaplan v. Goldsamt that, "Provided that the proxy statement viewed in its entirety sufficiently discloses the matter to be

voted upon, the omission or inclusion of a particular item is within the area of management judgment."

On April 3, 2013, the U.S. District Court for the Northern District of Illinois extended the reasoning of the Symantec decision in the case of Paul Noble v. AAR Corp. The court ruled that the plaintiff had established only harm to the corporation of the type that would require a shareholder derivative suit (as opposed to a direct suit), and also ruled as a matter of law that the sufficiency of disclosure on say-on-pay proposals is to be determined by reference only to the disclosures mandated by Section 951 of the Dodd-Frank Act and Item 402 of Regulation S-K. The ruling is significant in that earlier cases, including Symantec's ruling on preliminary injunction, relied heavily on "customary industry standard" with respect to the level of disclosure made by the defendant, as opposed to whether the reporting company had made the disclosures required by law.

The difference in scope between customary industry standards and statutory compliance is perhaps best highlighted by reference to the expert report Symantec prepared for purposes of its hearing on preliminary injunction. Symantec retained Stanford Law Professor Robert Daines to prepare a report comparing Symantec's disclosures with similar disclosures made by 15 peer firms and the top 26 high-technology hardware and software companies listed in the San Jose Mercury News's ranking of the "Silicon Valley 150." The report examined 21 different metrics for each reporting company and was set forth in a declaration that in its redacted form ran for 55 pages.

One of the most significant upcoming benchmarks in assessing the state of annual meeting proxy litigation is likely to come when the Superior Court of the County of Alameda issues its ruling in Mancuso v. The Clorox Company. The court previously declined to enjoin the annual meeting of Clorox based on allegations of inadequate disclosure related both to an advisory say-on-pay proposal and a binding proposal approving an expansion of the company's 2005 Stock Incentive Plan. When the court ruled on the preliminary injunction motion, it found that even a binding shareholder proposal voted on in the annual meeting was susceptible to "complete relief" because "these shareholder actions could be voided by court order, proxies re-solicited with full disclosures, and a new vote taken." In light of that earlier finding, it will be particularly notable if the Clorox court follows Symantec and AAR Corp. in finding that there is no direct shareholder harm once the vote has taken place.

It would also not be surprising to see the holdings in AAR Corp. followed by other state courts. State courts are likely to continue to entertain questions regarding the adequacy of proxy disclosures from direct plaintiffs in motions for preliminary injunction based on a substantial evidentiary showing, but will likely leave the assessment of damages post-vote to be determined by shareholder derivative actions.

Best Practices

Irrespective of whether most courts apply a "customary industry practice" or compliance-based analysis to reviewing the adequacy of proxy disclosures, reporting companies that are familiar with the disclosure policies of their peer companies in addition to complying with disclosure requirements can be expected to prevail. Reporting companies will also want to assess their general risk for proxy lawsuits in light of past shareholder voting trends, whether approval of equity incentive plans will be proposed to shareholders as part of an annual proxy solicitation, and past and anticipated recommendations from shareholder advisory firms such as ISS and Glass Lewis, as well as guidelines or communications with a reporting company's own institutional shareholders.

Recent decisions represent a positive trend for reporting companies with respect to the threat posed by shareholder proxy litigation. If it continues to be the practice that the merits of such claims are to be largely assessed based on a motion for preliminary injunction, reporting companies will want to be well prepared to defend the quality of their proxy disclosures so as to avoid what has threatened to be a new addition to the annual reporting calendar, that of the proxy litigation claim.

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