

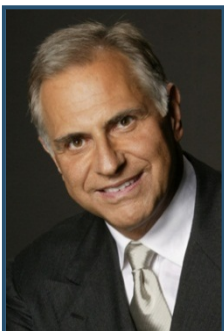
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Katten Muchin Rosenman LLP

THE GATHERING STORM: EQUITY COMPENSATION AND 10b5-1 PLANS UNDER ATTACK

January 15, 2013

Presenters



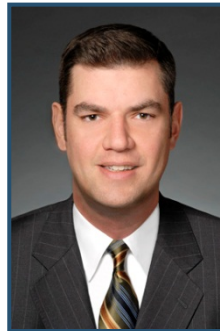
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The Genesis – Merger Objection Cases

- Since 2006, the plaintiffs' bar has brought suit to enjoin most mergers between public companies based on purported omissions in the merger proxy statements.
 - Today, around 95% of mergers involving public companies result in litigation.
- This is a significant threat of enjoining a merger vote if a lawsuit is filed.
 - A presumption exists that, if a merger closes without an adequately informed vote, irreparable harm will occur.
 - Thus, plaintiffs only had to show a likelihood of success on the merits, i.e., that the proxy included a material omission.
 - Materiality is a hard standard to beat early in litigation.
 - Most cases settle for additional disclosures plus attorneys' fees.
- These risks turned the lawsuits into a bountiful business for plaintiffs' lawyers.
 - With the popularity of the lawsuits has come an increase in settlement amounts.
 - Initially, attorneys' fees ranged from \$100K to \$250K. Today, they range from \$500K to \$1M.
 - Plaintiffs' lawyers can obtain these fees in exchange for very little work.

The New Wave of Injunction Cases

- In 2010, the Dodd-Frank Act's requirement of a "say-on-pay" vote gave plaintiffs another reason to bring suit. Following nearly every negative say-on-pay vote, plaintiffs sued, alleging that the board's approval of compensation, despite the negative advisory vote, constituted a breach of fiduciary duty.
 - Plaintiffs lost all but one of the cases. See *Gordon v. Goodyear*, 2012 WL 2885695, *10 (N.D. Ill. July 13, 2012) (collecting cases).
- In 2012, plaintiffs tried a new approach borrowed from the merger cases: Seeking preliminary injunctions of annual shareholder meetings based on purported omissions in the proxy statement.
- They have tried to enjoin annual shareholder votes on two primary bases:
 - Inadequate disclosures related to executive compensation in connection with the say-on-pay vote.
 - Inadequate disclosures regarding the dilutive effect of authorizing additional shares of common stock, or reserving stock for use in equity incentive plans.

The New Wave of Injunction Cases

- Faruqi & Faruqi has been at the forefront of this new wave.
 - Juan Monteverde.
 - Now their primary business model.
- Faruqi & Faruqi has been extremely active.
 - 24 pre-vote injunction lawsuits filed, including cases against Microsoft, Symantec and Clorox.
 - 32 additional investigations noticed.
 - Very successful in finding plaintiffs.
 - Serial plaintiffs – Natalie Gordon.
- Sometimes, they just send draft complaints and demand letters.

Say-on-Pay Injunction Cases

- Brought on the theory that the proxy fails to disclose sufficient information regarding executive compensation for shareholders to cast an informed “say-on-pay” vote.
- The pure “say-on-pay” cases, for the most part, have been unsuccessful at the preliminary injunction stage.
 - *AAR* (DuPage Cty., IL, filed Oct. 2, 2012): Say-on-pay vote, preliminary injunction denied, discovery stayed based on failure to state a claim, decision on motion to dismiss pending.
 - *Symantec* (Santa Clara Cty., CA, filed Aug. 31, 2012): Say-on-pay vote, preliminary injunction denied, defendants answered and case is proceeding.
- But Faruqi & Faruqi has indicated it intends to bring the pending cases (in which defendants have answered) to trial.

Share Issuance Injunction Cases

- Plaintiffs have also sought preliminary injunctions based on allegations that an annual proxy statement fails to disclose adequate information regarding share issuance and/or equity incentive plans. Based on plaintiff's success in the *Brocade* case (see below), they now argue that companies must disclose:
 - Projected “equity value of shares” being authorized.
 - Dilutive impact of authorizing the issuance of additional shares of common stock under the articles of incorporation.
 - Dilutive impact of reserving shares for use in an equity incentive plan.
 - Reason for issuing more shares for use in an equity incentive plan when the company has shares in reserve.

Share Issuance Injunctions

- Faruqi & Faruqi has had limited success obtaining preliminary injunctions:
 - *Brocade* (Santa Clara Cty., CA, filed Mar. 7, 2012): On April 10, 2012, the Santa Clara County Superior Court issued an order requiring Brocade to make additional disclosures prior to a shareholder vote on the issuance of additional shares for use in an equity compensation plan. The court later approved a \$625K fee award.

- Following *Brocade*, several other companies settled similar cases brought by Faruqi & Faruqi:
 - *Martha Stewart* (New York Cty, NY, filed May 16, 2012): Additional disclosures and at least \$125K in fees.
 - *WebMD* (New York Cty., NY, filed June 20, 2012): Additional disclosures and \$250K to \$350K (subject to court determination) in fees.
 - *H&R Block* (Jackson Cty., MO, filed Aug. 8, 2012): Additional disclosures and \$225K in attorneys' fees.

Share Issuance Injunctions

- Some defense victories:
 - *Amdocs* (New York Cty., NY, filed Jan. 13, 2012): Plaintiff voluntarily dismissed after we opposed his motion for a preliminary injunction.
 - *Ultratech* (Santa Clara Cty., CA, filed June 14, 2012): Preliminary injunction denied by the same court that decided Brocade, defendants answered, plaintiff filed an amended complaint, and case is proceeding.
 - *Plantronics* (Santa Cruz Cty., CA, filed July 13, 2012): Preliminary injunction denied, defendants answered and case is proceeding.
 - *Applied Minerals* (New York Cty., NY, filed Oct. 16, 2012): Plaintiff voluntarily dismissed after we moved to dismiss and the company voluntarily made further disclosures.

Post-Vote Derivative Cases

- Following the lead of Faruqi & Faruqi, Levi & Korsinsky begun noticing investigations into share issuance *after* the shareholder vote had occurred.
- Levi & Korsinsky has been very active noticing investigations—at least 15, most within the last month—but has only brought 3 cases of which we are aware based on share issuance.
 - They can take their time; in most instances, not trying to enjoin a vote.
 - The cases they have filed have been brought derivatively.
 - No decisions yet.
- Based on our review of the brief investigation notices they have issued, we believe they may bring lawsuits on the following theories:
 - Shares of common stock issued in excess of the amount authorized by shareholders;
 - Equity awards to executives or board members in excess of the number allowed by the shareholder-approved equity incentive plan; and
 - Executives selling too many shares, and thus not holding the minimum number of shares required by the corporate governance policy.

Post-Vote Derivative Cases

- Another theory, popular with Faruqi & Faruqi, Levi & Korsinsky, and other more established plaintiffs' firms (Robbins Umeda, Milberg), are allegations that a company failed to comply with, or adequately disclose the terms of, an IRC 162(m) Plan.
- IRC Section 162(m)—Imposes a corporate deduction limit of \$1M annually on compensation paid to named executive officers listed in the proxy (except the CFO), but allows exemptions to the deduction limit for “qualified performance-based compensation.” 162(m) Plans are plans implemented to take advantage of the performance-based exemptions.
- Limits on the amount of equity awarded to executives in a calendar year generally exist to ensure compliance with 162(m).

Post-Vote Derivative Cases

- Various theories:
 - Disclosure Claims—Defendant failed to adequately disclose performance goals, or disclosed it was in compliance with 162(m) when it had not complied with all of its restrictions (including issuing shares in excess of the number approved under the equity incentive plan).
 - Traditional Fiduciary Duty Claims—Failed to require compliance with performance goals.
 - Waste Claims—Issued compensation that is not “performance based” under 162(m), thus foregoing tax deductibility.
- The 162(m) cases have been brought primarily in Delaware.
 - Early plaintiffs’ success in *Archer-Daniels-Midland* (D. Del. March 28, 2011) and *Qualcomm* (D. Del. July 1, 2011).
 - The Delaware Court of Chancery, in *XTO Energy* (Del. Ct. Ch. Mar. 30, 2012), subsequently held that non-compliance with a 162(m) plan did not state a claim for waste.

Director Equity Grants

- Equity grants to directors may raise special issues.
 - In *Seinfeld v. Slager* (Del. Ct. Ch. June 29, 2012), the Court of Chancery granted in part and denied in part a motion to dismiss derivative claims related to excess compensation, holding that a claim that directors breached their fiduciary duties by granting themselves excessive compensation was not subject to the protection of the business judgment rule and had to be reviewed under entire fairness.
 - Entire fairness almost always means case cannot be dismissed on the pleadings.
 - We expect to see more lawsuits based on director compensation as a result of this decision.

How to Avoid Being Sued

- A solid proxy statement is the best preventative measure.
 - If the board or compensation committee might deviate from equity incentive plan award limits (by opting to forego 162(m) tax deductibility), specifically state this in the proxy.
- Retain outside counsel who have defended these cases to review draft disclosures.
- Advise Compensation Committee of the litigation risk.
- Build a record by drafting minutes with the expectation that they will be used in litigation.
- Submit equity plans for approval a year in advance.

How to Avoid Being Sued

- In connection with executive compensation (say-on-pay) votes, consider including in the CD&A:
 - The reasons the company selected its compensation consultant.
 - A “fair summary” of the compensation consultant analysis provided to the company’s board of directors.
 - The reasons the company selected the particular mix of salary, cash incentive compensation and long-term incentive compensation.
 - The reasons the company selected particular companies as peers for purposes of benchmarking compensation.
 - Details concerning financial and/or compensation metrics concerning peer companies.
 - Companies should be extra vigilant and consider going beyond the requirements of Items 402 and 407 of Regulation S-K to avoid being sued.

How to Avoid Being Sued

- In connection with votes to increase the number of shares authorized, or available for issuance under equity plans, consider disclosing:
 - Projections considered by the company's board concerning shares to be granted under equity incentive plans in the future.
 - The reasons that the company determined the number of additional shares requested to be authorized.
 - The potential equity value and/or cost of the authorization of additional shares.
 - The potential dilutive impact of the authorization of the additional shares.
 - A "fair summary" of any compensation consultant analysis provided to the company's board of directors.
 - More inclusion is better, and consider exceeding the requirements of Item 10 of Schedule 14A.
 - Even with these measures, there is always a risk of "tell me more" claims.

How to Avoid Being Sued

- After the annual meeting has occurred:
 - Watch the stock! Do not grant shares in excess of the authorized amount.
 - When hiring new executives, make sure grants do not exceed the number permitted to be issued to executives during a calendar or fiscal year (or disclose this possibility in the proxy statement).
 - If executives and directors are required to hold a certain number of shares, confirm that they do not fall below the minimum levels.
 - If your 162(m) plan requires a shareholder vote every 5 years, make sure the plan is put up for a vote accordingly.
 - These issues are of particular significance now as plaintiffs turn with a laser focus toward stock grant practices.

What to Do When You Are Targeted

- If you receive notice that your company is being investigated, contact outside counsel immediately.
 - Sometimes best to use someone other than usual corporate counsel, because some cases—particularly in the 162(m) and disclosure contexts—may have advice of counsel defense.
 - Use a lawyer experienced in these cases, who has a relationship with the firms bringing them, to try to stop a lawsuit before it is filed.
 - Consider making a preemptive disclosure of the investigation, and going on the offensive against the plaintiffs' firm.
- Expect a books and records demand, or potentially, a demand for settlement before a claim is filed.

After a Lawsuit Is Filed

- Notify insurance carriers.
- Assess goals—settlement, litigation.
- Consider removal to federal court.
 - This may require fast action, removing before the company is served.
- Review documents and assess strength of claim.

How Does Rule 10b5-1 Work?

- Section 10(b)/Rule 10b-5 prohibit trading “on the basis of” material nonpublic information in violation of a duty of trust or confidence.
 - Rule 10b5-1 defines “on the basis of” as being *aware* of material nonpublic information.
- Rule 10b5-1 was established as an affirmative defense to insider trading.
- Requirements of 10b5-1 affirmative defense:
 - Implement binding contract, instrument or written instructions (collectively, a “plan”) *before* becoming aware of material nonpublic information.
 - Plan must (i) specify number of securities to be traded, price and the date of trade, (ii) specify a formula or algorithm for determining number of securities, price and the trade date, *or* (iii) not allow the insider to exert any influence over how, when or whether trades occur.
 - Trades must occur *pursuant to* the plan, which precludes (i) altering the plan (whether by changing the amount, price or timing of trades) or (ii) entering into or altering a hedging plan with respect to the securities subject to the plan.
 - The plan must be implemented “in good faith and not as a part of a plan or scheme to evade the prohibitions” against insider trading.

How Are 10b5-1 Plans Typically Implemented?

- Insider selects selling broker, often from pre-approved list of brokers.
- Selling broker furnishes standard form 10b5-1 plan, often with pre-approved terms and conditions.
- Insider specifies trades or trading instructions (e.g., sell X shares per month or sell X shares whenever the stock hits Y price).
- Company confirm compliance with insider trading policy, including any 10b5-1 guidelines that the company may have in place.
- Insider enters into plan with broker during open trading period when not in possession of material nonpublic information.
- Plan effective (i.e., trades may begin) after a lag period.

The Wall Street Journal Series

- In a series of articles in late November and early December 2012, *The Wall Street Journal* echoed concerns about 10b5-1 trading plans voiced by commentators, that:
 - Trades in 10b5-1 plans tend to outperform the market;
 - Insiders may enter into plans when in possession of material inside information;
 - Insiders can exploit plans by cancelling them when a purchase or sale under the plan would be unfavorable; and
 - Insiders can time the disclosure of news to benefit pre-planned trades.
- The articles identified executives at 8 companies—Body Central, Micrel, VeriFone, Mohawk Industries, Cobalt International Energy, Cardtronics, Big Lots, and Hess Corporation—and suggested they had benefitted from favorably timed trades under Rule 10b5-1 plans.

Government Action

- Following the articles in November, the Manhattan US Attorney's Office and the SEC began investigations into the companies.
- One prior SEC enforcement action:
 - In 2009, the SEC initiated an enforcement action against Countrywide's CEO for, among other things, entering into a 10b5-1 plan while in possession of material nonpublic information. It settled the action in 2010 for \$22.5M (the largest penalty ever paid by an executive in an SEC settlement).

Private Litigation

- The private plaintiffs' bar followed immediately, announcing investigations into VeriFone, Big Lots, and Hess.
- Improper adoption of a 10b5-1 trading plan probably does not, standing alone, support a private cause of action for securities fraud.
 - Historically, the impact of a plan adopted in bad faith (with inside information) is that the plan cannot be used as an affirmative defense to insider trading allegations.
- Primary claim is more likely to be brought under Delaware law as a “Brophy claim” for insider trading. *Brophy v. Cities Serv. Co.*, 70 A.2d 5 (Del. Ch. 1949).
 - Brophy claims were thought to be dead until the Delaware Supreme Court revived them in 2011 in *Kahn v. Kolberg Kravis Roberts & Co., L.P.*, 23 A.3d 831, 838 (Del. 2011).
- Secondary potential “Caremark claim” against directors for failing to prevent alleged insider trading.

Factors to Consider in Working with 10b5-1 Sales Plans:

- Some actions, while not strictly prohibited under Rule 10b5-1, might undermine “good faith” requirement:
 - Overly complicated trading formula that is difficult for broker to execute/interpret.
 - Trading formula that results in too many shares rolling forward (e.g., as a result of price limit) so that a large number of shares sell on a single day.
 - Frequently amending plan after it’s established.
 - Terminating a plan before it’s completed, especially if insider will soon thereafter adopt a new plan.
 - Selling securities outside of the plan while a plan is in operation.
 - Timing public disclosures to benefit plan sales.
- Some actions are prohibited under the rule:
 - No concurrent “hedging transactions.”
 - Influencing the broker’s decisions regarding trading.
 - Sharing inside information with the broker executing plan trades.
- Keeping it simple and completing the plan as structured is usually best approach.

How to Promote Compliance

- Establish company policies and procedures for use of 10b5-1 plans.
- Establish company-approved prototype 10b5-1 plan.
- Require use of one or a limited number of company-approved brokers to sell securities pursuant to 10b5-1 plans (a “plan broker”).
- Publicly disclose adoption of key 10b5-1 plans on Form 8-K or quarterly or annual reports.
 - How much detail?
- Prohibit trades by insiders outside a 10b5-1 plan.
- Require a lag (e.g., 30 to 90 days) between adoption and effectiveness of 10b5-1 plan.

Best Practices to Promote Compliance

- Limit frequency of plan amendments (e.g., once or twice per year) and perhaps require change in personal circumstances.
- Require lag (e.g., 30 to 90 days) between terminating existing 10b5-1 plan and adopting new 10b5-1 plan.
- Provide for automatic termination of 10b5-1 plan at some point.
- Prohibit use of same broker for plan and non-plan trades.
- Retain right of company to terminate or suspend trading under 10b5-1 plans.
- Perhaps restrict types of permissible trading formulas.

What to Do if Sued

- We believe that the government, and the plaintiffs' bar, will be conducting statistical analyses to identify target companies.
 - Similar to options backdating, charting trades against peaks and valleys in stock prices, and against the dates of news releases.
- Companies may consider doing their own statistical analyses to determine whether obvious trading problems exist.
- If warranted, consider bringing in independent, outside counsel to conduct an internal investigation.
 - Greater credibility with regulatory authorities if self-reporting occurs.
 - Proactive steps by outside directors assist in defeating derivative and class actions.

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