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Shareholders Speak Up, Then They Sue: Derivative Lawsuits Follow Negative Say-on-Pay Votes

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Focus on corporate executive compensation levels and practices is at an all-time high, thanks in large part to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) enacted in 2010.[1] The Dodd-Frank Act mandated that public companies give their shareholders some say on executive pay, by allowing the shareholders to vote on non-binding resolutions regarding executive compensation. And perhaps not surprisingly, when the shareholders' voices have been ignored, lawsuits have followed. To date, shareholders have sued the boards of directors of at least nine companies that did not receive majority approval on say-on-pay proposals. These derivative suits have been filed in various state and federal courts across the United States. Two cases have already been settled, with the settling companies paying significant sums toward plaintiffs' attorney's fees and expenses. The potential for expensive and intrusive shareholder litigation is yet another reason for companies to take great care in crafting compensation policies and communicating with shareholders on compensation-related topics.

What Are Say-on-Pay Votes?

Section 951 of the Dodd-Frank Act provides that, no less frequently than every three years, public companies must provide their shareholders with an opportunity to vote on a resolution to approve or reject the compensation of certain of the company's executives. Section 951(c) specifically states that the shareholder voting results on these resolutions "shall be non-binding" on companies or their boards of directors and may ***not*** be construed:

1. As overruling a decision by the issuer or board of directors;
2. To create or imply any change to the fiduciary duties of the issuer or board of directors;
3. To create or imply any additional fiduciary duties for the issuer or board of directors; or
4. To restrict or limit the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation.

Legislative history of the Dodd-Frank Act confirms that the voting results on these "say-on-pay" resolutions are to be non-binding.[2]

The Securities and Exchange Commission adopted rules implementing the requirements of Section 951 that became effective on April 4, 2011.

1 Dodd-Frank Wall Street Reform and Consumer Protection Act, §14A(c), 15 U.S.C. § 78n (2010).

2 S. Rep. No. 111-176, at 133-34 (2010) (Report of the Committee on Banking, Housing, and Urban Affairs) stating that say-on-pay voting results "must be tabulated and reported, but the result is not binding on the board or management" of the company.

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The rules state that starting on January 21, 2011,[3] and not less frequently than once every three years thereafter, all public companies that are subject to the proxy rules are required at shareholder meetings to hold non-binding votes of the shareholders on the compensation of the CEO, CFO, and at least three other of the most highly compensated executives (*i.e.*, "say-on-pay votes").

How Have Shareholders Voted?

Approximately 290 say-on-pay votes were taken in 2010, and a majority of votes were cast against the company's compensation of named executive officers in only three instances — approximately 1 percent of the votes. So far in 2011, of the more than 2,800 companies that have reported say-on-pay voting results, more than 40 companies — or approximately 1.5 percent — did not receive majority shareholder support for their say-on-pay proposals.

What Is the Impact of a Negative Say-on-Pay Vote?

The fact that the majority of a company's shareholders disapprove of the company's executive compensation plan is clearly embarrassing and may create bad publicity. But the impact of a negative say-on-pay vote does not end there. In many cases, the next step after the negative vote — assuming the compensation packages are still paid despite the shareholder disapproval — is a shareholder derivative lawsuit against the company's directors, officers, and/or compensation consultants. These lawsuits generally allege that the officers and directors breached their fiduciary duties to the company and engaged in corporate waste. This trend was almost immediate; shareholder derivative lawsuits were filed against two of the three companies receiving negative say-on-pay votes in 2010 and, thus far, derivative lawsuits have been filed against seven of the companies that received negative say-on-pay votes in 2011. And of course, these lawsuits are expensive to defend.

In addition, a company receiving a negative say-on-pay vote may also incur substantial expense investigating whether the putative claims have merit and should be pursued by the company itself. That is, because these are shareholder derivative lawsuits seeking to bring claims on behalf of the company, the company may choose to create a special litigation committee. Such a committee would be tasked with conducting an investigation into whether any potential breaches of fiduciary duty were committed relating to historical and/or potential executive compensation, and determining whether it is in the best interests of the company to pursue the claims. These investigations are certainly intrusive and are also expensive.

Say-on-Pay Lawsuits — What Are the Claims?

Plaintiffs in these cases typically sue company directors and officers for corporate waste, unjust enrichment, breach of the duty of good faith and loyalty, breach of the duty of candor and full disclosure, false and misleading proxy statements, and breach of contract. Some plaintiffs have also sued the company's compensation consultants for breach of the consulting agreement and/or for aiding and abetting the directors' breaches of fiduciary duty. Shareholders generally seek unspecified monetary damages (which would benefit the company); equitable accounting against all recipients of challenged compensation; extraordinary or injunctive relief (including disgorgement, attachment, constructive trust, and/or impoundment of the compensation); an order requiring the implementation of internal controls to prohibit excessive compensation in the future; and attorneys' fees.[4]

These suits also generally argue that the award of the challenged compensation or the approval of a challenged compensation-related plan — despite the negative say-on-pay voting results and/or the company's unfavorable financial results/performance — was disloyal, irrational, unreasonable, and not in the shareholders' best interest.

Thus, plaintiffs in these suits assert that the decision was not the product of the valid exercise of the directors' business judgment.[5]

A sub-set of these suits also assert that compensation paid by the company was not only excessive, but also violated the company's own executive compensation

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3 These requirements were delayed for two years (until January 21, 2013) for "smaller reporting companies" (companies with public float of less than $75 million).

4 *See, e.g.*, *Plumbers Local No. 137 Pension Fund v. Davis*, 3:11-cv-00633 (D. Or. May 25, 2011) (derivatively, on behalf of Umpqua Holdings Corporation); *see also infra* notes 5 and 6.

5 *See, e.g.*, *Witmer v. Martin*, BC-454543 (Ca. Super. Ct. Feb. 4, 2011) (derivatively, on behalf of Jacobs Engineering Group Inc.); *King v. Meyer.*, CV 10-730994 (C.P. Cuyahoga County, Ohio July 6, 2010) (one of two suits filed derivatively, on behalf of KeyCorp, which were ultimately consolidated and removed to the U.S. District Court for the Northern District of Ohio).

"pay-for-performance" policies (e.g., that executive compensation will be based on, and aligned with, the company's earnings, revenues, shareholder returns, and/or other performance factors) and, in some cases, rendered certain of the company's prior representations that the company adheres to this "pay-for-performance" policy false and misleading.[6]

What Are the Available Defenses?

The claims are, at their core, typical derivative claims and thus are subject to the typical derivative claim defenses. This includes arguing that the plaintiff lacks standing due to a failure to make a demand on the board of directors.[7] But beyond the arguments that are typically made in derivative cases, there are also a number of arguments specific to say-on-pay votes that are available to defendants.

First, as noted above, the Dodd-Frank Act and its legislative history are clear — the results of shareholder voting on say-on-pay proposals "shall be non-binding" on companies or their boards of directors and may not be construed to create or imply any change to a director's fiduciary duties or to impose any additional fiduciary duties.

Second, U.S. courts — most notably those in Delaware — have often seemed reluctant to intervene in matters relating to executive compensation. Delaware courts generally consider decisions about executive compensation to be matters of business judgment and entitled to deference by the courts. *See*, e.g., *In re InfoUSA, Inc. S'holders Litig'n*, 953 A.2d 963, 985 (Del. Ch. 2007). Thus, company directors are given wide latitude under the business judgment rule to set corporate compensation policy and structure executive compensation agreements that they believe are in the corporation's best interest.

Third, a negative say-on-pay vote, without more, will likely not constitute sufficient evidence of bad faith, lack of due care, or waste by a corporate board of directors to overcome the business judgment rule on a motion for summary judgment or at trial. The Delaware Supreme Court has recognized the following three types of acts by corporate fiduciaries as examples of bad faith: (1) intentionally acting with a purpose other than that of advancing the best interests of the corporation; (2) acting with an intent to violate applicable positive law; and (3) intentionally failing to act in the face of a known duty to act, demonstrating a conscious disregard for the corporate fiduciary's duties. *In re Walt Disney Co. Deriv. Litig'n*, 906 A.2d 27, 64-67 (Del. 2006). The third of these examples requires "a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists." *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006). A violation of the duty of good faith requires a showing that the directors knew that they were not discharging their fiduciary obligations. *Id.* at 369-70. In other words, mere procedural defects or directorial inattention are not sufficient.

With regard to the duty of care, the analysis is a process inquiry, not a substantive one, which requires only that the decision-makers be informed of all reasonably available material information and exercise the level of care of a reasonably prudent person in similar circumstances. *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000). Further, except for situations in which the directors' actions were grossly negligent or their decision was so unconscionable as to constitute waste or fraud, under Delaware General Corporation Law,[8] directors are protected from liability if they rely in good faith on an outside compensation consultant as to matters the director reasonably believes are within the consultant's professional or expert competence if that consultant was selected with reasonable care by or on behalf of the corporation. *Id.* at 262.

Finally, to prevail on a waste claim, under well-settled Delaware law, a derivative plaintiff would need to demonstrate that the company directors "authorize[d] an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." *In re Walt Disney Co. Deriv. Litig'n*, 731 A.2d 342, 362-63 (Del. Ch. 1998). Thus, successful waste claims are "confined to unconscionable cases where directors

[6] *See, e.g.*, *Swanson v. Weil*, 1:11-cv-02142-CMA (D. Colo. Aug. 16, 2011) (derivatively, on behalf of Janus Capital Group Inc.); *Haberland v. Bulkeley*, (E.D.N.C. Sept. 1, 2011) (derivatively on behalf of Dex One Corporation).

[7] In Delaware and other U.S. jurisdictions, derivative plaintiffs must either make pre-suit demand on the board of directors of the corporation to take action to correct the wrongdoing or plead particularized facts sufficient to establish that such a demand would be futile. *See Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); Del. Ch. Ct. R. 23.1(a).

[8] Del. Code. Ann. Tit. 8 § 141(e) (2011).

irrationally squander or give away corporate assets." *Brehm*, 746 A.2d at 263.

Thus, under currently prevailing law, so long as a corporate board's decisions related to executive compensation were made with a belief that such decisions would be in the corporation's best interest (e.g., to retain executives or to reward them for achieving certain pre-selected performance objectives) and the directors (1) reasonably informed themselves, (2) employed appropriate procedures in making compensation-related decisions (including some meaningful discussion or deliberation over such decisions), and (3) reasonably relied on compensation experts (if any) that were selected with reasonable care, then a negative say-on-pay vote — or any manifestation of shareholder disagreement with the board's ultimate decisions on executive compensation, for that matter — is not likely to be sufficient, in and of itself, to overcome the presumptions of the business judgment rule on bad faith, lack of due care, or waste grounds.

How Are These Claims Faring in Court?

The two companies that were named in say-on-pay derivative suits in 2010 have settled those lawsuits. In connection with these settlements, both companies agreed to implement certain corporate governance enhancements and pay significant sums towards plaintiffs' attorney's fees and expenses. KeyCorp, in particular, agreed to pay $1.75 million in attorneys' fees and expenses.[9] KeyCorp also agreed to shorten the exercise period for options previously granted to the company's CEO.[10]

Motions to dismiss have also been filed in several other derivative suits, but so far only two such motions to dismiss have been decided. In *Beazer Homes*, on September 16, 2001, Judge Melvin Westmoreland of the Superior Court of Fulton County, Georgia rejected "as wholly unpersuasive both factually and legally" plaintiffs' argument that adverse say-on-pay voting results, without more, constitute evidence that rebuts the presumption that the Beazer directors' *prior* compensation decisions reflected valid business judgment.[11] The court further held that the Dodd-Frank Act expressly preserved, and did not alter, the preexisting fiduciary framework regarding directors' executive compensation decisions.[12] In *Cincinnati Bell*, however, on September 20, 2011, Judge Timothy Black of the United States District Court for the Southern District of Ohio ***denied*** defendants' motion to dismiss.[13] Judge Black ruled that plaintiff had pleaded sufficient factual allegations to "raise a plausible claim that the multi-million dollar bonuses approved by the directors in a time of the company's declining financial performance violated Cincinnati Bell's pay-for-performance compensation policy and were not in the best interests of Cincinnati Bell's shareholders and therefore constituted an abuse of discretion and/or bad faith."[14] *Cincinnati Bell*, therefore, is a case to watch.

Conclusion

While say-on-pay proposals under the Dodd-Frank Act are non-binding on company directors, a negative say-on-pay vote can trigger a number of possibly adverse effects on a company, not the least of which is the filing of a shareholder derivative suit. While such derivative suits may ultimately lack merit, defending such suits can be expensive, distracting, and intrusive. And at least one case has survived a motion to dismiss and is proceeding into the discovery phase. Thus, an ounce of preventative attention paid to executive compensation best practices up-front may prevent the expensive headache of shareholder litigation later. ■

The Rise of Federal Merger-Challenge Lawsuits and the Hurdles Plaintiffs Face

By Kenneth P. Held and Ronald L. Oran

The pattern is familiar: A proposed merger or acquisition involving a publicly traded company is announced and almost immediately law firms issue press releases announcing "investigations" into whether the target company and its board of directors breached their fiduciary duties. The press releases encourage shareholders who would like to know more about their rights to contact the

9 KeyCorp, Current Report (Form 8-K) Exhibit 99.2, at 16-17 (Mar. 25, 2011).

10 KeyCorp, Current Report (Form 8-K), at 2 (Mar. 25, 2011).

11 *Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy*, 2001-CV-197841 at 10 (Super. Ct. GA Sept. 16, 2011) (order granting motion to dismiss).

12 *Id.* at 11-12.

13 *NECA-IBEW Pension Fund v. Cox*, 1:11-cv-00451-TSB (S.D. Oh. Sept. 20, 2011) (order denying motion to dismiss).

14 *Id.* at 6.

law firm. Then — sometimes as soon as within 24 hours of the announcement of a transaction — merger-challenge lawsuits begin to be filed in the state courts of the target company's state of incorporation and the state in which it is headquartered. They allege breaches of state-law fiduciary duties based on allegations that the purchase price is too low and the result of a flawed process, that the deal protection devices in the merger agreement are preventing the target from obtaining higher offers, and — after the preliminary proxy statement is filed with the Securities and Exchange Commission (SEC) — that the disclosures made to the target's shareholders are insufficient. Increasingly now, however, another set of lawsuits is being filed: federal securities-fraud lawsuits alleging disclosure violations under Section 14(a) of the Securities Exchange Act.

A recent analysis of securities class-action filings found that almost one-fourth of all securities class-action lawsuits filed in the first half of 2011 challenged the disclosures made to a company's shareholders in connection with a proposed merger or sale of the company.[15] This continues a trend that began last year[16] and is likely an outgrowth of the recent large increase in the number of public-company mergers that are challenged in state-court lawsuits.[17] Despite this increase in Section 14(a) suits, however, it is not clear that federal merger-challenge lawsuits will, in the long term, provide a viable alternative to state-law fiduciary-duty claims.

As we explain, plaintiffs face a number of strategic and tactical problems in bringing what are essentially state-law fiduciary-duty causes of action as federal securities-law claims. The usual form that merger-challenge lawsuits take and the manner in which they typically are prosecuted in state courts simply are not compatible with federal law, especially the Private Securities Litigation Reform Act (PSLRA). Therefore, while the current increase in federal-court merger-challenge lawsuits is likely to continue for now, such cases may decline as the case law catches up with the plaintiffs' bar's ingenuity.

Increased Competition for State-Law Merger-Challenge Work Is Leading Law Firms to File Federal Actions.
Probably the most significant factor leading to the increase in federal merger-challenge lawsuits is that the market for law firms that file these lawsuits appears to be over-saturated.

A meritorious merger-challenge lawsuit can generate tens of millions of dollars in fees. But even a meritless merger-challenge lawsuit can generate tens of thousands, if not hundreds of thousands, of dollars in fees, as companies frequently settle groundless lawsuits simply to gain deal certainty and because often such lawsuits can be settled for significantly less than the cost of defending them.[18]

Moreover, the barriers to entry are relatively low for a plaintiff's attorney who wants to do merger-challenge work. All an attorney needs is a shareholder who is willing to serve as a plaintiff. Even if that shareholder owns just one share, that is sufficient to allow the attorney to file a lawsuit and have a chance of getting some portion of any fees generated. If that lawsuit is also the first filed, then the lawyer has a significant chance of controlling the subsequent lawsuits that normally are filed and consolidated in a particular jurisdiction.[19] An attorney can attempt to find a shareholder willing to serve as a plaintiff simply by issuing a press release posted to the internet announcing an "investigation" of the proposed transaction that insinuates that it is unfair and that encourages shareholders who want to know more about their rights to call the law firm.

A good illustration of this is the proposed acquisition of El Paso Corporation by Kinder Morgan, Inc., which was announced on October 16, 2011. That same day, law firms began announcing "investigations," and within a couple of days of the announcement, at least 11 law firms had

15 Cornerstone Research, Securities Class Action Filings Report: 2011 Mid-Year Assessment, available at: www.cornerstone.com/files/Publication/ef3dc0f2-d0a2-478a-b8bc-363297b27252/Presentation/PublicationAttachment/f7d9395c-faa7-44a3-a807-37f8eac5e1c7/Cornerstone_Research_Filings_2011_Mid_Year_Assessment.pdf.

16 *Id.* at 14 (citation omitted).

17 Tom Hals and Jonathan Stempel, *Analysis: Merger Lawsuits Increase — as Do the Legal Fees*, ("Lawsuits challenging mergers tripled to 335 in 2010 from 107 just three years earlier even as deal volume dropped, according to Advisen, a provider of research to insurers"), available at: www.reuters.com/article/2011/02/11/us-shareholder-lawsuits-idUSTRE71A4HI20110211.

18 A quick settlement of a weak merger-challenge lawsuit usually involves the company making additional disclosures in its merger-related SEC filings, and then, after agreeing on those disclosures, it will agree to pay attorneys fees to the law firm or firms that brought the merger-challenge lawsuit. Because such suits are typically brought as class actions on behalf of all shareholders, these settlements usually are subject to court approval.

19 The typical forums for these cases are the state and federal courts of the state in which a company is incorporated and headquartered.

issued press releases announcing "investigations." Within nine days of the announcement, at least seven lawsuits challenging the proposed transaction had been filed in Texas state courts, with nine more being filed in Delaware state courts. These cases likely will be consolidated in each of those two forums. After an initial proxy statement is filed with the SEC, one can expect another round of law-firm press releases with a new law firm — or one of the firms that failed to gain a significant stake in the consolidated state-court lawsuits — then filing a federal lawsuit alleging violations of Section 14(a) of the Securities Exchange Act and Rule 14a-9 in Texas or Delaware.

Federal Merger-Challenge Lawsuits Are Usually State-Law Fiduciary Duty Claims Stretched Thin to Fit a Section 14(a) Mold.[20]

A plaintiff in a state-court merger-challenge lawsuit typically seeks to enjoin the merger based on allegations that it is the product of breaches of fiduciary duty by the target company's board of directors. The plaintiff will usually allege that: (1) the disclosures related to the proposed transaction are inadequate; (2) the deal protection mechanisms agreed to by the parties unfairly prejudice the target company's ability to receive or consider a better offer; and (3) the sales process was flawed and led to an unfair transaction price. The plaintiff usually will seek to have a preliminary injunction hearing set before any shareholder vote on the proposed transaction, and he will move for expedited discovery prior to that hearing. If the plaintiff can get both expedited discovery and a quick hearing on a motion for temporary injunction, then he can maximize his ability to threaten the proposed transaction and, therefore, his leverage in settlement negotiations.

Federal merger-challenge plaintiffs have typically followed the same pattern. They make similar allegations regarding transaction price and process, and they allege that shareholders are not being provided sufficient information to allow them to cast an informed vote for or against the proposed transaction. There is no federal-law cause of action, however, that covers the transaction price or process. And, as discussed below, the disclosure obligations under federal law are narrower than the obligations under state law. Many federal merger-challenge lawsuits still try to shoehorn state-law disclosure claims into federal-law claims, though, by focusing on the fact that Delaware courts employ the definition of materiality used under federal law.[21] This does not, however, mean that Rule 14a-9 is coextensive with the state law duty to disclose all material information.

Section 14(a) proscribes soliciting a proxy in contravention of SEC rules and regulations.[22] Section 14(a) and Rule 14a-9 provide a claim for relief only where a proxy statement either: (1) does not include information required by the SEC's rules, or (2) contains a materially false or misleading statement.[23] Rule 14a-9 provides that no proxy statement shall contain "any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading . . . ."[24] Thus, federal law does not require disclosure of *all* information a shareholder might like.

It Is Impossible for Most Plaintiffs to State Disclosure Claims That Satisfy the PSLRA.

The PSLRA requires a plaintiff bringing claims under the Securities Exchange Act to "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading" and to state with particularity all facts on which a belief is based when pleading on information and belief.[25] This means that a plaintiff must make particularized allegations demonstrating that any allegedly omitted information is material and necessary to make some statement made in a proxy statement not misleading. An omitted fact is material only "if there is a *substantial likelihood* that a reasonable shareholder would consider it *important* in deciding how to vote . . . . Put another way, there must be a *substantial likelihood* that the disclosure of the omitted fact would have been viewed by the reasonable investor as having *significantly altered* the 'total mix' of information made available."[26]

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20 *See*, *e.g.*, *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 99 (2d Cir. 2001). ("[F]ederal security laws were not intended to 'bootstrap' garden-variety state law claims of breach of fiduciary duty into federal securities claims for failure to disclose.")

21 *See Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 945 (Del. 1985) (adopting materiality test from *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976)).

22 15 U.S.C. § 78n(a).

23 *Id.*

24 17 C.F.R. § 240.14a-9(a).

25 15 U.S.C. § 78u-4(b)(1).

26 *TSC Indus., Inc.*, 426 U.S. at 449.

In a typical Section 14(a) that is not a merger-challenge lawsuit, either shareholders have discovered after the fact that some statement made in proxy-soliciting materials was false or misleading, or communications sent to shareholders are alleged to be proxy solicitations that do not meet the SEC's explicit requirements or were not filed with the SEC. Federal merger-challenge cases are different.

In federal merger-challenge cases, the plaintiff is seeking additional information, for example, details regarding fairness opinions, other opportunities available to a target company, or the process by which the agreement to enter into the proposed transactions was reached. The plaintiff does not know the allegedly omitted information; in fact, the crux of the complaint is that he is asking for that information so that he can cast an informed vote. Without knowing the allegedly omitted information, however, a plaintiff cannot have a plausible belief that there is a substantial likelihood that a reasonable investor would think it significantly alters the total mix of information presented in a proxy statement — the test for materiality. Similarly, a plaintiff cannot have a plausible belief that the omission of information makes some statement in a proxy statement misleading.[27] Therefore, the plaintiff should not be able to meet the PSLRA's enhanced pleading requirements.

It Is Difficult for Federal Securities Plaintiffs to Gain Quick Leverage.

In addition to pleading burdens imposed by the PSLRA, there are also timing difficulties inherent in federal securities litigation under Section 14(a) that make it difficult to employ the same tactics one would in state court merger challenges. Namely, the PSLRA's mandatory stay of discovery during the pendency of a motion to dismiss and the fact that Section 14(a) claims are not ripe until proxies are actually solicited make it difficult for a plaintiff to put the proposed transaction in immediate jeopardy.

The PSLRA Erects Significant Hurdles to Expedited Discovery.

Plaintiffs often try to create pressure to settle by threatening expedited discovery. Not only can such discovery be expensive, but it can also cause directors and senior management to have to prepare for and attend a deposition instead of focusing on the proposed transaction and it can provide the plaintiffs with discovery that they can use to try to find a more viable claim for relief. That, however, is what the PSLRA was in part meant to prevent.

The PSLRA was enacted "to restrict abuses in securities class-action litigation, including . . . (2) [the] targeting of 'deep pocket' defendants; (3) the abuse of the discovery process to coerce settlement; and (4) manipulation of clients by class action attorneys."[28] To prevent these abuses, the PSLRA incorporates the heightened pleading standard discussed above.[29] It also stays discovery and other proceedings in all securities actions while a motion to dismiss is pending.[30]

This mandatory stay protects defendants from the burden of discovery prior to a ruling on a motion to dismiss. It also "avoid[s] the situation in which a plaintiff sues without possessing the requisite information to satisfy the PSLRA's heightened pleading requirements, then uses discovery to acquire that information and resuscitate a complaint that would otherwise be dismissed."[31] Accordingly, "[u]nless *exceptional circumstances* are present, discovery in securities actions is permitted only after the court has sustained the legal sufficiency of the complaint."[32]

Federal merger-challenge lawsuits often present exactly the abuses that the PSLRA was meant to control. They are filed quickly, often without any regard to merit, and they are used to extract settlements by threatening a company's business (the proposed transaction) and forcing it into expensive discovery. While mergers often occur in relatively short order, the PSLRA affects all federal merger-challenge litigation in the same way;

27 *Hysong v. Encore Energy Partners, LP*, C.A. No. 11-781 (D. Del. Oct. 18, 2011) (rejecting Plaintiffs' counsel's motion to lift the PSLRA based on claim that discovery was needed to enjoin a merger based on Section 14(a) claims).

28 *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 531 (3d Cir. 1999) (citing H.R. Conf. Rep. No. 104-369, at 28 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 748).

29 *In re Alpharma Inc. Sec. Litig.*, 372 F.3d 137, 147 (3d Cir. 2004).

30 15 U.S.C. § 78u-4(b)(3)(B) (emphasis added).

31 *Sarantakis v. Gruttaduaria*, No. 02 C 1609, 2002 WL 1803750, at *1 (N.D. Ill. Aug. 5, 2002); *see also In re NAHC, Inc. Sec. Litig.*, 306 F.3d 1314, 1332 (3d Cir. 2002) ("The PSLRA's stay of discovery procedure was intended by Congress to protect innocent defendants from having to pay nuisance settlements in securities fraud actions in which a foundation for the suit cannot be pleaded.").

32 *In re Vivendi Universal, S.A., Sec. Litig.*, 381 F. Supp. 2d 129, 130 (S.D.N.Y. 2003) (emphasis added) (citation and internal quotation marks omitted).

therefore, unless courts decide to adopt a categorical exception to the PSLRA stay (which no court has done), there generally will not be any exceptional circumstances that would allow a plaintiff to circumvent the PSLRA stay. Indeed, two courts recently applied the PSLRA discovery stay to *deny* discovery to plaintiffs seeking to enjoin mergers based on claims under Section 14(a).[33]

Plaintiffs Typically File Their Lawsuits Before Any Proxies Are Solicited.

Federal merger-challenge lawsuits are generally filed when a preliminary proxy statement is filed with the SEC. State-court breach of fiduciary duty claims, however, are usually filed even before the preliminary proxy is filed, and the claims can be amended to include disclosure claims after the preliminary proxy is filed. Thus, the state-court plaintiffs usually have a head start in prosecuting their claims. Section 14(a) claims likely are not ripe until a *definitive* proxy statement is sent to shareholders.

Section 14(a) and Rule 14a-9 prohibit "solicitation . . . by means of a proxy."[34] Rule 14a-1(1) defines "solicit" and "solicitation" to include only requests for proxies that are reasonably calculated to result in the giving or withholding of a proxy.[35] It includes: "(i) any request for a proxy whether or not accompanied by or included in a form of proxy; (ii) any request to execute or not to execute, or to revoke, a proxy; or (iii) the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding, or revocation of a proxy."[36] Accordingly, to state a claim under Section 14(a) and Rule 14a-9, the defendants must have "*actually solicited* proxies," *i.e.*, they must have requested proxies or furnished a proxy statement to shareholders.[37]

This puts law firms filing federal merger-challenge lawsuits in the position of choosing between: (1) filing unripe claims at a time when the state-court lawsuits may not have progressed too far, or (2) waiting until their claims are ripe, at which time state-court lawsuits may very well be settled already, which means these law firms risk missing out on any piece of the fees paid. So far, law firms that file federal merger challenges generally have decided to file unripe claims, but as the case law on this issue catches up with the current trend, it may become easier to get premature claims summarily dismissed on this basis.

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These problems with federal merger-challenge lawsuits should lead to the development of case law favorable for companies that chose to litigate the merger-challenge lawsuits, and they may reduce the proliferation of these suits. They are not, however, likely to prevent plaintiffs firms from filing these cases or to keep them — in some instances — from being able to use the federal forum to gain some portion of any settlement a company may choose to enter into. ■

33 *Davis v. Duncan Energy Partners L.P.*, Civil Action No. H-11-2486, 2011 WL 3518263, at *5 (S.D. Tex. Aug. 10, 2011); *Hysong*, No. 11-781 (D. Del.).

34 *Ferro v. Blankenship*, No. EP-95-CA-004-DB, 1999 WL 35125518, at *3 (W.D. Tex. Mar. 17, 1999).

35 17 C.F.R. § 240.14a-1(1).

36 *Id.*

37 *Ferro*, 1999 WL 35125518, at *3; *see also Flannery v. Tesoro Petroleum Corp.*, No. Civ. SA-95-CA-1298, 1999 WL 35125519, at *1 (W.D. Tex. Feb. 2, 1999) ("[A]n actual solicitation must be made before plaintiffs can be accused of making an improper solicitation.").

One Surprising Winner Under Dodd-Frank: The SEC's Enforcement Division

By Jason A. Levine and Rebecca Rice Fike

Introduction

The recent financial crisis has led to much regulatory ferment, along with public outrage at the apparent lapses of market oversight by the U.S. Securities and Exchange Commission (SEC or the Commission). One outgrowth of this phenomenon is the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which (in part) required the SEC to hire an independent consultant to assess its internal operations, structure, funding, and relationship with Self-Regulating Organizations (SROs) in an effort to identify "improvements" to the Commission.[38] The assessment was conducted by the Boston Consulting Group, which spent six months reviewing documents, analyzing data, and interviewing hundreds of current and former SEC officials, regulated entities, peer regulators, SROs, and industry groups. The result is a 263-page BCG

38 Dodd-Frank Wall Street Reform and Consumer Protection Act, § 967, 15 U.S.C. § 78n (2010).

Report (Report), published on March 10, 2011, and setting forth 16 specific recommendations in four categories.[39]

Of particular interest to issuers and regulated entities is whether and how any of these recommendations — if implemented — will affect the SEC's Division of Enforcement (Enforcement or the Division). Ironically, although Enforcement is included in the Report, it appears that this SEC Division's own damage-control steps at reorganization in the wake of the Madoff scandal spared it from being the subject of any material criticism or recommendations in the Report. Indeed, Enforcement will benefit from recommendations involving more rational allocation of cases among regional offices, personnel enhancements, and additional co-opting of SROs' resources, and these benefits do not appear to require any diversion of resources or funds from Enforcement's budget. Accordingly — and ironically — it appears that Enforcement will emerge a winner under Dodd-Frank.

Pre-BCG Report Efforts To Improve Enforcement

The SEC's own reorganization of Enforcement, which began in 2009, provides important context for the Report. Heralded in the Report and elsewhere as an SEC success story, the restructuring of Enforcement was initiated by the SEC with the goal of increasing the efficiency and expertise with which the Division handles its case. Of chief impact, a new "Managing Executive" position was created and charged with project management and division-wide operational workflow, and a new "Office of Market Intelligence" was made responsible for collecting, risk-weighting, triaging, and referring tips, complaints, and referrals. In addition, five new national units were dedicated to highly-specialized and complex areas of the securities industry (Asset Management, Market Abuse, Structured and New Products, Foreign Corrupt Practices Act, and Municipal Securities and Public Pensions), a move that has already proven successful. Although only approximately 25 percent of Enforcement personnel are assigned to specialized units, which draw upon all of the regional offices,[40] the result has been a flexible network of experts that has brought the entire Division closer together. This increase in cooperation among the 11 regional offices has been one of the most positive side-effects of the reorganization. The 11 Regional Directors and their Associate Directors now have weekly meetings by videoconference, and a Cooperation Committee was established to assist with cooperation between Headquarters and the regional offices.

Notably, former SEC General Counsel and Chairman Harvey Pitt recently testified before Congress about the Report and pending legislation aimed at reforming the SEC.[41] Along with chastising Congress for broadening the SEC's mandate without increasing its budget, Mr. Pitt praised the reorganization of Enforcement. He noted that, to date, the reorganization has eliminated a full layer of management to streamline the Division's internal management and processes, creating immediate efficiencies. Mr. Pitt also observed that the ongoing success of Enforcement's reorganization, and the fact that the SEC *voluntarily* undertook that process, demonstrates that the Commission can be relied upon to respond intelligently and effectively to its responsibilities. Criticizing Dodd-Frank, Mr. Pitt further commented that it has undermined the SEC's impetus to improve itself, by mandating the creation of new divisions and by dictating the manner in which those new divisions are worked into the chain of command. Only time will tell whether Mr. Pitt's opinions will prove correct, but it is clear that the reorganization of Enforcement at least blunted the impact of the Report, given that its recommendations do not directly involve — but secondarily benefit — Enforcement.

Recommendations of the Report and Their Likely Effects on Enforcement

The Report contains information, analysis, and commentary on nearly every aspect of the SEC. Overall, the vast majority of its recommendations relate to the organizational structure and regulatory activities of the SEC other than Enforcement, although the implementation of these recommendations will have ripple effects on Enforcement. As described by the Report, its 16 "optimization initiatives" fall into four self-described categories: (1) reprioritizing regulatory activities; (2) reshaping the organization;

[39] The full text of the BCG Report is available at www.sec.gov/news/studies/2011/967study.pdf.

[40] In addition to its headquarters in Washington, D.C., the SEC has regional offices in Atlanta, Boston, Chicago, Denver, Fort Worth, Los Angeles, Miami, New York, Philadelphia, Salt Lake City, and San Francisco.

[41] Written Testimony of Harvey L. Pitt, "Fixing the Watchdog: Legislative Proposals to Improve and Enhance the SEC," before the House Financial Services Committee (September 15, 2011), available at: http://financialservices.house.gov/UploadedFiles/091511pitt.pdf.

(3) investing in infrastructure; and (4) enhancing the SRO engagement model.

To **Reprioritize Regulatory Activities**, the Report tasks the SEC with undertaking a "rigorous" assessment to identify its highest-priority needs in regulatory policy and then reallocate its resources accordingly. This category is at least partially a result of the Report's overarching conclusion regarding the chasm between the SEC's resources and its responsibilities. Because the SEC cannot make every recommendation its first priority, this first initiative lays out an internal, "reprioritizing" approach to improving regulation. This is particularly important as the SEC's market oversight (or perceived lack thereof) has been the subject of much intense public criticism, particularly in the wake of the Madoff and Allen Stanford scandals. The Report breaks this initiative into four sub-categories: (1) high priority activities that SEC management deems critical to strengthen commerce; (2) activities that the SEC could, if necessary, scale back or stop entirely; (3) activities where the SEC could consider delegating responsibilities externally (e.g., to SROs like FINRA); and (4) congressionally-mandated activities where SEC management could request implementation flexibility. Although regulation is the flip-side of enforcement — the law-making counterpart to Enforcement's prosecution of law-breaking — this initiative does not appear to portend any direct, near-term effects on Enforcement's activities, given the Division's already high priority at the SEC.

In **Reshaping the Organization**, the Report recommends systematically redesigning the structure, roles, and governance of the SEC's many divisions in light of its reprioritized regulatory activities (noted above). Of particular interest to Enforcement is the recommendation that the SEC review its regional model because there appears to be no articulated strategy for the location, activities, or roles of the 11 regional offices. Enforcement is one of several divisions that likely suffers from a lack of clarity and duplication of roles among the offices. For example, cases are currently assigned based on the geographic nexus of the activity underlying the case; but because headquarters (in Washington, DC) has no assigned geographic jurisdiction, there are often turf battles over the assignment of cases, plus duplication of work, before the official assignment occurs. A review of the strengths and expertise of regional personnel could go far in ensuring that cases are quickly and appropriately assigned. Separately, the Report recommends seeking flexibility from Congress on certain new Dodd-Frank mandated "offices" — four of which are supposed to report directly to the Commissioners — which the Report finds will be less efficient than incorporating these new divisions into the existing hierarchy. Whether any of these "offices" might be rolled into Enforcement is not yet determined. It is clear, however, that a more rational approach to regional office utilization will benefit Enforcement by improving efficiency and decisiveness in enforcement matters.

In **Investing in Enabling Infrastructure**, the Report encourages the SEC to enhance its existing technology to improve the availability and sharing of information, and to execute a redesign of the Office of Human Resources. If the recommended Technology Center for Excellence is implemented, this could greatly aid Enforcement in the fact-finding and market analysis aspects of their cases. Additionally, the Report recommends a redesign of the Office of Human Resources, an enhanced role for the HR manager, a centralized training program for SEC personnel, and the roll-out of a new performance management system. The Report also discusses the SEC's need to hire and retain personnel with certain high-priority skills. For Enforcement, this could be experienced trial attorneys, as well as top-tier candidates from the private sector with experience in securities litigation. Accordingly, it is likely that this initiative will result in an enhancement to the quality and effectiveness of Enforcement's legal personnel.

Fourth and finally, the Report describes an initiative dedicated to **Enhancing the SRO Engagement Model**. SROs are endowed by statute with regulatory authority over specific segments of the market and the power to make policy, survey markets, mandate registration of market participants, and coordinate peer regulators. Examples of SROs include the stock exchanges (NYSE, NASDAQ), market oversight organizations (FINRA, FASB), and clearing corporations (National Securities Clearing Corporation, Options Clearing Corporation). The SEC oversees these activities through inspections or approving SRO rule proposals, and may also regulate alongside them when pursuing joint enforcement actions. The Report notes that the SEC has come to rely heavily on SROs as the financial markets have become more technical and the volume of trading has greatly outpaced the increase in SEC funding. While this is to be expected, and may in fact be a good way to stretch the SEC's budget, the Report suggests the creation of a central coordinating

body to oversee the SROs, ensure their compliance with certain regulations, and also ensure that the SEC fully benefits from their expertise. If unfunded, of course, this mandate could divert some portion of SEC resources away from Enforcement. Otherwise, it is likely to benefit Enforcement because greater co-opting of SRO personnel and expertise could improve the reach and scope of Enforcement's activity.

Conclusion: What Lies Ahead for Enforcement and the SEC?

The SEC has formally responded to the Report,[42] as required by Dodd-Frank, and Mary Schapiro, current Chairman of the SEC, has testified before the U.S. House of Representatives Committee on Financial Services regarding the SEC's response.[43] In general, the SEC's reaction has been positive and the Commission is well under way executing some of the Report's more urgent recommendations.

One point the Report makes, and one that both Mr. Pitt and Chairman Schapiro emphasized in their remarks before Congress, is the need to close the ever widening gap between the SEC's congressional mandate and its funding. The Report flatly challenges Congress to either give the SEC the resources it needs to fulfill its extensive list of responsibilities (a list that is only lengthened by Dodd-Frank), or to narrow its responsibilities in light of its current level of funding. Dodd-Frank requires the SEC to write and enforce over 100 new rules and expands the SEC's regulatory and enforcement activities to cover managers of private funds, derivatives, credit rating agencies, asset-backed securitization, and corporate governance reform.

Although Enforcement is the indirect beneficiary of the Report's recommendations, the increased responsibilities imposed on the SEC by Dodd-Frank — if left unfunded — could strain Enforcement resources as a trickle-down effect of strains on the Commission overall. Given the prominent public role of Enforcement, however, it seems certain that Congress (and the SEC itself) will do all they can to prevent this situation. Accordingly, in all likelihood, it appears that Enforcement will emerge from Dodd-Frank a winner — despite the fact that its own lapses were a primary impetus for Dodd-Frank and the Report in the first place. ■

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42 The SEC Report on the Implementation of SEC Organizational Reform Recommendations was made public on September 9, 2011 and is available at: www.sec.gov/news/studies/2011/secorgreformreport-df967.pdf.

43 Chairman Schapiro testified before the Committee on September 15, 2011, full remarks available at: www.sec.gov/news/testimony/2011/ts091511mls.htm.

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