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Shareholder Derivative Suits After Negative Say-On-Pay Votes

Litigating Executive Compensation Challenges and Minimizing Exposure to Lawsuits

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SHAREHOLDER SUITS AFTER NEGATIVE SAY-ON-PAY VOTES

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Say-on-Pay Litigation

- Brief Introduction to say-on-pay litigation
- Overview of the legal standards and history of executive compensation cases
- Dodd Frank's requirements for executive compensation
- Current status of say-on-pay cases and their future
- In-depth analysis of case law
- How a board should react to say-on-pay votes

Say-on-Pay Litigation: An Introduction

- 2011 saw a new type of shareholder derivative action based on failed shareholder votes on executive compensation under the new Dodd Frank "say-on-pay" provisions.
- These provisions went into effect January 1, 2011 and apply to shareholder meetings taking place on or after January 21, 2011.
- They require an ***advisory*** shareholder say-on-pay vote at least once every three years to approve a company's senior executive compensation.
- No vote is required to approve a compensation system or philosophy.

Say-on-Pay Litigation: An Introduction

- The overwhelming majority of companies "passed" the say-on-pay vote when their shareholders voted to approve the executive compensation.
- Only about 50 companies failed a say-on-pay vote in 2011. Of these, only about 35% experienced shareholder derivative actions.
- After a failed say-on-pay vote, plaintiffs typically look for an increase in executive compensation while shareholder value declined or a disconnect between one company's executive compensation and its peer group.

Executive Compensation Cases: Legal Standards and History

- Delaware and other state courts have consistently held that compensation decisions are protected by the business judgment rule, which is a presumption that the board acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company.

Executive Compensation Cases: Legal Standards and History

- A plaintiff seeking to file a derivative suit on behalf of a corporation, must either demand action from the corporation's board or plead why such demand would have been futile. Otherwise, the complaint will be dismissed.
- Usually, to survive a MTD, plaintiff must plead particularized facts that create a reasonable doubt that either (1) the directors were disinterested and independent, or (2) the challenged transaction was the product of a valid exercise of business judgment. <u>In re Aronson v. Lewis</u>, 473 A.2d 805 (Del. 1984).

Executive Compensation Cases: Legal Standards and History

- To challenge business judgment, a plaintiff must show
  - a reasonable doubt that the action was taken honestly and in good faith; or
  - a reasonable doubt that the board was adequately informed in making the decision.
- Another layer of difficulty
  - Delaware law permits a company's certificate of incorporation to provide that, with narrow exceptions, a director shall not be liable "for monetary damages for breach of fiduciary duty . . . ." 8 Del. Code § 102(b)(7).
  - As a result, plaintiffs "must also plead particularized facts that demonstrate that the directors acted with scienter, *i.e.*, there was an 'intentional dereliction of duty' or 'a conscious disregard' for their responsibilities, amounting to bad faith." In re Goldman Sachs Group, Inc. S'holder Litig., No. 5215, 2011 WL 4826104 at *41 (Del. Ch. Oct. 12, 2011).

Executive Compensation Cases: Legal Standards and History

- Delaware courts have recently gone to great lengths to emphasize how difficult it is for plaintiffs to bring executive compensation cases:
  - A board's decision on executive compensation is "entitled to great deference." <u>In re Tyson Foods, Inc. Consol. S'holder Litig.</u>, 919 A.2d 563, 588 (Del. Ch. 2007).
  - Compensation decisions are "a core function of a board of directors exercising its business judgment." <u>In re Goldman Sachs Group, Inc. S'holder Litig.</u>, 2011 WL 4826104 at *6.

Executive Compensation Cases Legal Standards and History

- Throughout history, plaintiffs have rarely been able to meet the high standard of executive compensation cases. Courts have consistently found that a breach of fiduciary duty in connection with a compensation decision occurs only in egregious situations.
- For example, in options backdating cases, when directors consciously violated stated stock option policies and knowingly lied to shareholders.

Executive Compensation Cases: Dodd-Frank

- Dodd Frank is express and unambiguous: say-on-pay votes are advisory and “shall not be binding on the issuer or the board of directors of an issuer, and may not be construed (1) as overruling a decision by such issuer or board of directors; (2) to create or imply any change to the fiduciary duties of such issuer or board of directors; [or] (3) to create or imply any change to the fiduciary duties for such issuer or board of directors.”
- “The Dodd Frank Act *expressly preserved* the pre-existing fiduciary duty framework concerning directors’ executive compensation decisions.” <u>Teamsters Local 237 Additional Security Benefit Fund v. McCarthy</u>, No. 2011-97841, 2011 WL 4836230, at *8 (Ga. Super. Ct., Sept. 16, 2011).

Say-on-Pay Litigation

- Despite Dodd Frank's express language, plaintiffs try to use a failed say-on-pay vote to overcome the previously near-insurmountable business judgment standard.
- Typical Allegations:
  - The failed vote is direct evidence that the executive compensation is not in the best interest of shareholders;
  - The board of director's approval of the executive compensation was not a valid exercise of business judgment, a violation of stated pay-for-performance policies, and a breach of their fiduciary duties to the company;
  - The executive officers were unjustly enriched by the excessive compensation; and
  - Occasionally aiding and abetting breach of fiduciary duty allegations against the company's compensation consultant.

Say-on-Pay Litigation: Note for Compensation Consultants

- Consultant can rely on defenses of the company and its individual board members ***AND***
- Argue that stricter demand futility test applies: plaintiff can't rely on rebutting the business judgment rule; it must show that the board was not independent from and disinterested towards the consultant. Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993).
- *In Pari Delicto*

Say-on-Pay Litigation: Summary of Decisions

- Six of seven opinions on whether a failed say-on-pay vote rebuts the business judgment presumption answered in the negative.
- The lone opinion answering in the positive, <u>Cincinnati Bell</u>, has been highly criticized by legal commentators and other courts.

Say-on-Pay Litigation: The Future

- While the inconsistent holding in Cincinnati Bell creates some risk, it appears unlikely that corporations will face liability in a shareholder derivative suit for a failed say-on-pay vote based on the overwhelming weight of authority.
- But it appears that failed votes do get a board's attention and changes are being made.
  - For example, one in every four of the companies with a failed vote installed a new CEO and one in five got a new CFO.
  - According to the WSJ, the total compensation of at least 65 CEOs grew less than their companies' increases in performance.
  - All companies that failed a say-on-pay vote made changes to secure a favorable vote the following year.
- In fact, one survey found that companies are likely to make changes to a compensation program in anticipation of shareholder disapproval.

2011 Say-On-Pay Lawsuits

- The usual suspects:
  - The Weiser Law Firm
  - Robbins Geller Rudman & Dowd

1. **Settled**

   a. ***King v. Meyer*** **(Keycorp) – (Ohio Com. Pleas)**

- **Filed - 7/6/2010 ; Settlement Agreement – 3/25/11**
- **Required to hold an advisory vote on 2009 executive comp in 2010 as a result of participating in the Troubled Asset Relief Program**
- **Plaintiffs alleged demand was futile; court said demand required**
- **Special Committee (SC) formed, affirmed Board and Compensation Committee (CC) acted properly and rejected demand in its entirety.**
- **But, adopted comprehensive set of recommendations made by the SC to the full Board.**
  - **incentive compensation shall be tied primarily to performance measures; length-of-service measures shall be used sparingly.**
  - **Incentive compensation to include risk adjustments where appropriate.**
  - **KeyCorp shall develop a policy for dealing systematically with the impact that extraordinary events have on incentive compensation awards.**
  - **CC to consider retaining compensation consultant independent of the compensation consultant who recommends compensation plans and performance targets, and also retaining independent counsel for the CC.**

- **<u>Additional Settlement Terms</u>**
  - Results of the annual say-on-pay vote shall be one of the discretionary factors used by the CC re: evaluating reduction of executive compensation for poor performance or excessive risk
  - The Board or the CC shall issue a formal response in the event of a majority negative vote
  - CC shall amend its charter to state that a director generally shall not serve on the COC for more than five (5) consecutive years
  - $1.75 million for attorneys' fees and expenses to Weiser; $5,000 for plaintiff

b. *<u>Resnik v. Abraham</u>* (Occidental Petroleum Corporation) – (D. Del.)

- Filed - 5/20/10; Settled – 2/8/11 (court approval)
  - adopted "say-on-pay" vote prior to Dodd-Frank
  - 2 state cases filed in California were dismissed
  - Settlement terms not disclosed

2011 Say-On-Pay Lawsuits

2. Pending Suits

   a. *Matthews v. Hercules Offshore* (S.D. Tex.)

      - Filed - 6/8/11
      - Motion to Dismiss Pending

   b. *Freedman v. Bruch* (Bank of New York Mellon) - (Supreme Ct. of NY County)

      - Filed - 6/21/11

   c. *City Of Sterling Heights Police & Fire Retirement System v. Kratz* (Helix Energy Solutions Group, Inc.) – (S.D. Tex.)

      - Filed 7/11/11)

   d. *Haberland v. Dex One Corp* - (E.D.N.C.)

      - Filed - 9/1/11
      - Motion To Dismiss Pending

   e. *George Leon Family Trust v. Coleman et al* (Johnson & Johnson) – (D.N.J.)

      - Filed - 9/1/2011.
      - Section 14(a) claim and failure to adhere to pay-on-performance standards in 2011 Proxy statement but no reliance on say-on-pay vote

3. Orders Entered

a. *Jacobs Engineering Group v. Martin* – (California Superior Ct. in LA: filed 2/4/11)

b. *Teamsters Local 237 v. Beazer* - (Georgia Superior Ct. of Fulton County; filed 3/15/11)

c. *Plumbers Local No. 137 v. Umpqua* - (D. Ore.; filed 5/25/11)

d. *NECA-IBEW Pension Fund v. Cox* (Cincinnati Bell) - (S.D. Ohio; filed 7/5/11)

e. *Dennis v. Hart et al*. (PICO Holdings) – (S.D. Cal.; filed 8/16/11 in Calif. Superior Ct. San Diego, removed to federal court)

f. *Laborers' Local v. Intersil* (N.D. Cal.; filed 8/19/11)

g. *Weinberg v. Alan Gold, et al* (BioMed Realty Trust) – (D. Md.; filed 9/2/11)

NECA-IBEW Pension Fund Derivatively on behalf of Cincinnati Bell, Inc. v. Cox et al., Case No. 1:11-cv-451 (W.D. Ohio Sept. 20, 2011)

Defendants

- 7 Directors (5 on Board Compensation Committee)
- 3 Officers: President and CEO; CFO; VP and General Counsel
- Executive compensation advisory firm (Towers Watson & Co.)

Plaintiff's Claims

- Against directors for breach of duty of loyalty.
- Against officers for unjust enrichment.
- Against compensation consultant for aiding and abetting breaches of fiduciary duties of directors.

***Cincinnati Bell, Inc. v. Cox et al*., Case No. 1:11-cv-451 (W.D. Ohio Sept. 20, 2011)**

Facts

- 2011 proxy materials said Cincinnati Bell's executive comp. program was based on pay-for-performance

- Company's 2010 performance was poor
  - 68.4% decline in net income ($89.6 million to $28.3 million)
  - Negative 18.8% annual shareholders' return
  - 75.7% decline in earnings per share ($0.37 to $0.09)
  - 2% decline in stockholders' equity

- 3 top executives' compensation increased
  - 71.7% to $8.6 million for CEO/Pres. ($4 million in bonuses on top of $4.5 million in salary and other comp.);
  - 80.3% to $1.4 million for CFO; and
  - 54.3% to $1.4 million for VP/Gen'l Counsel.

- 66% of voting shareholders rejected the executive compensation proposals in a May 2011 SH vote.

Plaintiff's Theory of Liability

1. Board's increase of executive compensation despite "disastrous" financial results was "disloyal, irrational and unreasonable and not the product of a valid exercise of business judgment."
2. Pay hikes violated the Company's pay-for-performance policy.
3. Overwhelming rejection of executive pay hikes by SHs' (most of whom were sophisticated institutional investors) on the basis of the same facts known to the Board constituted "direct evidence" that the Board did not act in the SHs' best interests.
4. Negative say-on-pay vote rebuts presumption that Board's decision was valid exercise of business judgment and shifted burden to Defendants to show the decision was independent, made in good faith and in the SHs best interests
5. Demand excused because the entire Board faced a substantial likelihood of liability for breach of loyalty.

Magistrate's decision denying Defendants' Motion To Dismiss

1. Applied Ohio law, which follows the business judgment rule ("BJR"), i.e., courts will not inquire into wisdom of actions taken by directors in the absence of fraud, bad faith or abuse of discretion.
2. Ohio statute provides that directors liable only if there is "clear and convincing" evidence that actions were taken "with a deliberate intent to cause injury to the corporation or a reckless disregard for the best interests of the corporation."
3. Plaintiff bears burden of establishing facts at trial rebutting presumption of good faith on part of directors; but does not have to plead facts in the complaint that rebut the presumption.
4. Plaintiff pled adequate facts to show Cincinnati Bell Board not entitled to protection of BJR
5. Awarding multi-million bonuses when company's financial performance was declining "violated [its] pay-for-performance compensation policy and [was] not in best interests of Cincinnati Bell's shareholders and therefore constituted an abuse of discretion and/or bad faith."

Cincinnati Bell, Inc. v. Cox et al., Case No. 1:11-cv-451 (W.D. Ohio Sept. 20, 2011)

Magistrate's decision excusing Plaintiff from pre-suit demand as futile

1. Ohio Law: Plaintiff must show facts demonstrating that presumed ability of directors to make unbiased, independent business judgments regarding whether it is in corporation's best interests to file the action does not exist.
2. Showing directors are targeted as wrongdoers not enough by itself to excuse demand
3. Demand presumptively futile where directors are
   - Antagonistic
   - Adversely interested
   - Involved in the transactions attacked.
4. Delaware Law: Demand excused when Plaintiff's allegations create reasonable doubt that challenged transaction is result of a valid business judgment.
   - That is actually one of two disjunctive prongs of Delaware test under *Aronson*
5. Plaintiff's factual allegations create doubt that directors could make unbiased, independent business judgments regarding filing of suit.
   - Pay hikes devised and approved by Defendants who also recommended SH approval in proxy materials and suffered negative SH vote.
   - All directors sued (Two Ohio cases say suing all directors establishes futility.)
   - Magistrate doesn't explain why this is any different than merely showing directors are targeted as wrongdoers

Cincinnati Bell, Inc. v. Cox et al., Case No. 1:11-cv-451 (W.D. Ohio Sept. 20, 2011)

Not necessarily a stunning victory for the Plaintiffs.

- Court said Defendants can offer BJR as affirmative defense at trial, when Plaintiff "may well not be able to prove by clear and convincing evidence that the directors acted with a 'deliberate intent to cause injury to the corporation' or 'reckless disregard for the best interests of the corporation.'"
- In December 2011, Cincinnati Bell announced settlement of SH derivative lawsuit in state court related to its negative say-on-pay vote (as opposed to the federal court case discussed above).
- Appears to be similar to settlement in the KeyCorp litigation, announced in March 2011.
- Proposed settlement Order:
  - **"Generally, the settlement terms fall into four general categories: (1) empowering and/or improving the policies of the Board's Compensation Committee; (2) improving communications by the Board and the Company to Cincinnati Bell's stockholders, (3) enhancing the independence of the Board and rotating membership on the Compensation Committee; and (4) providing for the retention of an additional executive compensation consultant if a majority of the shareholders vote against the executive compensation proposed by the Compensation Committee."**
- In the KeyCorp case, settlement included award of plaintiff's legal fees of $1.75 million. Fees in Cincinnati Bell not yet announced.

<u>Teamsters Local 237Additional Security Benefit Fund et al. v. McCarthy et al.</u> **(Beazer Homes USA, Inc.), Civil Action No. 2011-cv-19784I (Ga. Super. Ct. Sept. 16, 2011)**

1. Complaint filed March 15, 2011.
   a. Robbins Geller Rudman & Dowd - Same as in *Cincinnati Bell*
2. <u>Plaintiff's Claims (as in Cincinnati Bell)</u>:
   a. Against directors for breach of duty of loyalty.
      - Added breach of duty of candor and good faith
      - Added claim that recommendation to vote for compensation was materially false and misleading because directors failed to disclose raises were excessive and irrational based on Company's 2010 results

   b. Against officers for unjust enrichment.

   c. Against compensation consultants for aiding and abetting breaches of fiduciary duties of directors.
      - Added breach of contract.

   d. 53.7% of SHs voted against compensation

   e. $34 million net loss in 2010 and negative 17.23% annual shareholders' return.

   f. Top executives' compensation increased on average 68.4%; 37% and 150% for CFO, GC and CAO/Controller; 7.2% for CEO/Pres., to $6.9 million; 37% for CFO to $3.5 million;

Beazer Homes USA, Inc (Ga. Super. Ct. Sept. 16, 2011)

3. But Proxy statement also noted the following, as indicated in Complaint:

   a. In prior years mgt. increased stockholders' equity by over $200 million, restructured $585 million of debt and raised $300 million in new equity;

   b. CEO had not had base salary increase since 2005; base salaries of CFO, GC and

   c. CAO frozen since 2007, 2009 and 2008, respectively;

   d. CEO had no equity grant since 2006;

   e. 2008 bonuses reduced from 1.875 times base salary actually earned to half of base salary

4. Plaintiff's Theory of Liability

   a. Board's decision to increase executive compensation despite Beazer's poor performance was "disloyal, unreasonable and not the product of a valid exercise of business judgment." (Left out "irrational" until later??!!??)

   b. Negative say-on-pay vote = SH's conclusion that pay hike not in best interests of SHs and rebuts presumption of BJR

   c. Pay hikes violated the Company's pay-for-performance policy

   d. Board's recommendation in Proxy Statement to vote for 2010 executive compensation was materially false and misleading as it failed to disclose that raises were excessively large, irrational, violated the company's pay for performance policy and were not the product of a valid exercise of business judgment.

5. Plaintiff's allegations re: demand futility [same as in *Cincinnati Bell*]:

   a. Entire Board faced a substantial likelihood of liability for breach of loyalty and are therefore interested in the outcome;

   b. Not entitled to BJR, which was rebutted by SH vote.

   c. Board approved raises, then recommended SH approval of excessive comp. and then failed to rescind raises after failed say-on-pay vote (1 of only 5 companies that failed to obtain approval). This demonstrated Board hostility toward relief sought by Plaintiff.

Order Granting Defendants' Motions To Dismiss (Sept. 16, 2011)

1. Defendants' Arguments
   a. Plaintiffs' failed to allege contemporaneous and continuous ownership of Beazer stock.
   b. Plaintiffs' failed to allege legal excuse for failure to make demand.
   c. Plaintiffs' failed to state a claim upon which relief may be granted
   d. Court found dismissal warranted on each of the three grounds (b and c = dicta)
2. No stock ownership
   a. Challenged 2010 comp was paid based on specific incentive performance goals established by Comp Committee at outset of fiscal 2010; guidelines set forth in 2010 equity incentive plan
   b. Goals and plan disclosed to investors in February 25, 2010 Proxy Statement and were approved by 89% of SHs at April 13, 2010 annual SH meeting, before Plaintiffs bought Beazer stock in May 2010.
   c. Complaint in no way suggested that challenged compensation was not paid in accordance with those terms.
   d. Plaintiffs bought stock before amounts actually paid, but can't complain that execs paid what they earned in accordance with guidelines Plaintiffs knew (actually or constructively) when they bought stock.

3. Court's holding that demand not excused

a. Under *Aronson v. Lewis* (Beazer is Delaware corp) where Board decision is challenged, complaint must allege particularized facts raising a reasonable doubt that either

(i) a majority of the Board was "disinterested" (*i.e*., not motivated by any unique personal financial interest in the decision in the sense of self-dealing) and "independent" (free from the dominion and controlling influence of another "interested" party); OR

(ii) the challenged decision was the result of a valid exercise of business judgment.

b. If Plaintiff not attacking any particular decision, *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993) applies, *i.e*., must allege particularized facts sufficient to raise a reasonable doubt that a majority of the directors could have exercised independent and disinterested business judgment in responding to the demand.

Beazer Homes USA, Inc (Ga. Super. Ct. Sept. 16, 2011)

- Disinterested issue: of 7 directors, only one received any of the compensation at issue.
- Independence issue: Plaintiff did not allege majority of directors under dominion or control of CEO or any of the other officers who received the comp at issue.
- Plaintiffs' focus was on second prong; raising reasonable doubt that directors' compensation decisions reflect valid business judgments
- Presumption under Delaware law is that they did so.
- No particularized allegations that decisions were not made on an informed basis (due diligence) or in good faith and honest belief they were in the company's best interests.
- No allegation that comp not awarded in manner consistent with executive's performance relative to predetermined financial and non-financial goals.

Plaintiffs Argument:

- Adverse say-on-pay vote is evidence that rebuts presumption that the Board's prior decisions (approving the challenged compensation and recommending Beazer SHs vote for it) reflected valid business judgments

Court's Response:

- Outcome of the vote not known to Board at time of their decisions, so they could not have considered it;
- Vote does not establish Board did not act on an informed basis, in good faith and with honest belief that their decisions were in Beazer's best interests.
- No authority supports "novel contention" that negative say-on-pay vote is "evidence" regarding whether plaintiffs have rebutted the BJR.
- Has no support in either Delaware law or Dodd-Frank Act.
  - **[N.B. How about the Dodd-Frank Act itself????]**
- Act expressly says vote not binding and cannot be construed as overruling a Board's decision, create or imply any change to fiduciary duties or create or imply an additional fiduciary duties.
- Delaware law gives directors "wide discretion" to set compensation.
- Failure to allege particularized facts rebutting BJR presumption = failure to allege excuse for failure to make demand.

Failure to rescind does not rebut BJR or excuse demand

- Dodd-Frank says “no” vote does not require rescission;
- No support for notion that failure to do so is not a valid business judgment;
- No facts alleged that decision not to rescind was uninformed, in bad faith or not in honest belief it was in Company’s best interests.

Allegations that Beazer Board faces “substantial likelihood of liability” insufficient.

- Must allege particularized facts that a majority of the Board faces substantial likelihood of liability
- Plaintiffs’ allegations of omission of material facts from Proxy statement are conclusory and not particularized (*e.g*., failed to disclose that compensation was “excessively large and irrational”).
- Plaintiffs’ allegations show comp paid pursuant to executive’s achievement of pre-established performance targets and terms of 2010 Equity Incentive Plan approved by SHs.
- Company’s poor performance was not omitted from Proxy statement; disclosed in 10-K filed in November 2010.

Beazer Homes USA, Inc (Ga. Super. Ct. Sept. 16, 2011)

<u>Alleged Board hostility to Plaintiffs' claims insufficient to excuse demand</u>

- Board approval of challenged transactions not sufficient to establish hostility
- Such a rule would render demand requirement meaningless

<u>No basis alleged on which demand excused re: claims v. consultants</u>

- *Rales* test applies to excuse of demand regarding claims against consultants for aiding and abetting and breach of contract.
- Requires particularized facts creating reasonable doubt that majority of directors <u>could have</u> exercised independent and disinterested business judgment in responding to demand.
- All of Plaintiffs' demand futility allegations relate to why Board would not sue themselves, not why it would not sue third parties.
- In briefs, Plaintiffs argued claims v. consultants stemmed from wrongful conduct of Board but cited no supporting authority and similar argument rejected in *Garcia v. Carrion*, No. Civ. A. 09-1507 (JAG) 2010 WL 3662593, at *11 (D.P.R. Aug. 11, 2010).
- No reason 6 of 7 directors could not have disinterestedly and independently considered demand to sue execs for unjust enrichment

4. Court's Ruling That Complaint Failed To State A Claim

   a. Failure to state a claim for breach of fiduciary duty re: compensation decisions because failure to allege particularized facts rebutting BJR presumption.

   b. Failure to state a claim re: omissions from Proxy statement

      - No identification of material facts withheld from SHs
      - No misrepresentations re: exec. comp policies

   c. Failure to state a claim for aiding and abetting against consultants

      - Failure to allege any underlying breach of fiduciary duty upon which to premise an aiding and abetting claim
      - Failure to identify specific conduct; failure to meet even notice pleading requirements

   d. Failure to state a claim for breach of contract against consultants

      - No specific contract or contract provision identified

   e. Failure to state a claim for unjust enrichment

      - No allegation execs' comp at odds with achievement of established performance targets or terms of Equity Incentive Plan.
      - Allegation that comp excessive because Beazer lost money is conclusory and insufficient basis for unjust enrichment claim.

Plumbers Local No. 137 Pension Fund v. Davis et al. **(Umpqua Holdings Corp.), Case No. 3-11-cv-00633-AC (D. Ore. Feb. 23, 2012)**

- Complaint: Filed May 25, 2011. (Robbins Geller Rudman & Dowd)
- Defendants:
  - 10 Directors: (5 on Board Compensation Committee; 1 also the President and CEO)
  - 4 Officers: President and CEO; COO; CFO; Senior Credit Officer
  - Exec comp. advisory firm
  - Umpqua is bank holding company incorporated in Oregon.
- Plaintiff's Claims (as in *Cincinnati Bell* & *Beazer*):
  - Against directors for breach of duty of loyalty.
    - Mentions breach of duty of candor and good faith, which were dropped in Beazer
  - Against officers for unjust enrichment.
  - Against consultant for aiding and abetting breaches of fiduciary duties of directors and breach of contract.

Umpqua Holdings Corp., Case No. 3-11-cv-00633-AC (D. Ore. Feb. 23, 2012)

- Company's 2010 performance was poor
- Overall, Umpqua's 2010 executive compensation increased, on average, 118.8%.
  - CEO's pay jumped 61.1 % to over $3.7 million.
  - COO's pay increased 112.4% to $1.5 million
  - CFO's pay increased 140.6% to $880,000.
  - Senior Credit Officer's pay increased 161.2% to $897,000.

- Proxy statement stated:
  - An independent Compensation Committee that engages its own advisors and consultants;
  - Stock ownership guidelines and a "hold to retirement" policy for executives;
  - Grants under performance-based equity incentive plans;
  - Prohibition on repricing stock options;
  - Annual incentive plans tied to Company earnings; and
  - A compensation recoupment or clawback policy.
  - "Our program for compensation of named executive officers was approved by our shareholders in each of the last two years
- 62% of SHs on April 19,2011, rejected comp as recommended by Board

Orders Granting Defendants' Motions To Dismiss:

- Magistrate's Decision: Jan. 11, 2012
- Judge's Decision: Feb. 23, 2012

- Defendants' Arguments:
  - Plaintiffs' failed to allege legal excuse for failure to make demand.
  - Plaintiffs' failed to state a claim upon which relief may be granted

- Magistrate's Decision: Plaintiffs failed to meet their burden with respect to presuit demand requirement

- Court adopted Magistrate's decision

Complaint failed to note that Proxy Statement indicated that

- compensation for 2009 "reflected ... [significant] effects of the recession and ... impact of the housing market downturn and increasing unemployment;"
- in 2009 Company raised capital through a public offering; increased mortgage banking revenue; and initiated new community, commercial, and international banking operations;
- having received "capital investment from the U.S. Treasury in 2008" Umpqua accepted the compensation limitations attached to that investment for 2009 and 2010;
- when limitations were lifted in 2010, the Compensation Committee made a considered decision to "normalize" compensation of its executives.
- in determining base salary for executive officers, Board commissioned an executive compensation study and a "benchmarking study" both of which provided guidance regarding executive base salaries
- Umpqua's comp policy rewards performance with comp based on both financial and non-financial metrics;
- set forth the "performance categories" that executives were expected to focus on, including
  - **financial targets as measured by operating earnings per share ("OEPS");**
  - **leadership;**
  - **regulatory compliance; and**
  - **the executives' particularized goals**.
- executives rewarded with incentive pay because met their collective and independent goals
- Few months after adverse SH say-on-pay vote (62% “no”), the Board notified Umpqua shareholders that, in light of the results, the Board would endeavor to "more closely link executive compensation to stock price and dividend performance.”

Magistrate's decision demand not excused

1. Applied *Aronson* two-pronged disjunctive test
2. Defendants argued that only one board member, Umpqua CEO, received compensation as a result of the approval, and that Plaintiffs did not adequately allege he exercised control over other board members (First Prong).
3. Plaintiffs countered that
   a. where directors would likely be subject to liability for the challenged actions, they cannot be considered disinterested; and
   b. a benefit by a single board member may excuse demand where, as here, that board member is in a leadership position or otherwise wields significant influence.
4. Magistrate held: A majority of the board was not interested by way of direct benefit such as to avoid the presuit demand requirement.
5. Rejected *Cincinnati Bell* holding supporting Plaintiffs' "novel theory" that the interest required to excuse the demand required is present because the board members face a "substantial likelihood" of liability
   a. Assumes self-interest sufficient to trigger demand futility is present whenever board members face the possibility of a lawsuit filed against them in response to a decision or other board action - - would erase demand requirement.
   b. N.B. Law in fact is that mere threat of potential liability is not enough to establish director not able to exercise independent judgment, but substantial likelihood of liability based on particularized facts is.

Second Aronson Prong

- "[T]he `plaintiffs must allege particularized facts that raise doubt about whether the challenged transaction is entitled to the protection of the business judgment rule.' Specifically, the `plaintiffs must plead particularized facts sufficient to raise

  (1) a reason to doubt that the action was taken honestly and in good faith or

  (2) a reason to doubt that the board was adequately informed in making the decision.'" *In re J.P. Morgan*, 906 A.2d at 824 (quoting *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275, 286 (Del. 2003).

- Plaintiffs argue that the SH vote is prima facie evidence that the board's action was not in the corporation or SHs' best interests and requires Defendants to prove that the board exercised rational business judgment in approving the compensation package.

- Defendants argue
  - Dodd-Frank explicitly provides that it does not create a distinct basis for liability;
  - SH disagreement with a board's decision does not exempt the decision from the business judgment rule — that is what boards do and why we have them — so long as the board acts in good faith.

- Plaintiffs counter that in light of the poor performance of Umpqua and the SH say-on-pay vote, it is impossible to justify the board's compensation vote.
  - **"Plaintiffs contend this is corroborated by the board's subsequent statement that, in the future, it would link performance and pay more closely ("pay for performance"), characterizing this as an admission against interest that the board's action was unreasonable. Finally, Plaintiffs argue that . . . concealment or misrepresentation of material facts is not protected by the business judgment rule."**

Magistrate’s decision re: 2nd Aronson Prong

- “Board's actions do not directly defy or violate any Umpqua bylaw, any shareholder agreement, or any legally mandated disclosure or reporting requirement.”

- “Plaintiffs rely on a policy, pay for performance, that does not establish a binding standard for compensation and, notably, the board's statement regarding pay for performance was not made until after the compensation package had been approved.”

- “Plaintiffs' essential position is that if a simple comparison reveals a level of compensation inconsistent with general corporate performance, the business judgment presumption is necessarily overcome, a position that is unsupported by the applicable standards.”

Umpqua Holdings Corp., Case No. 3-11-cv-00633-AC (D. Ore. Feb. 23, 2012)

- Magistrate rejected attempt to rebut BJR based on allegations of false and misleading Proxy statements.
  - "In specific instances the presumption may be overcome where a board of directors, although acting within the letter of a stockholder-approved plan, engages in deceptive conduct or misrepresents the true nature of its actions."
  - Because allegation that board violated pay-for-performance policy not sufficient to overcome the business judgment presumption, allegation that board made a material misrepresentation by not saying pay violated that policy is likewise insufficient.
  - Second, alleging that board's decision does not square with Plaintiffs' interpretation of the pay-for-performance policy ≠ an allegation that the board intentionally misled shareholders that it would follow the policy when, instead, it had no intention of doing so.
  - Complaint's allegations do not dispel the presumption that the board's compensation decision can be attributed to any rational business purpose. [**NB: This is actually the Rales test]**

Judge's Decision

- Adopted Magistrate's decision and dismissed complaint without prejudice and with leave to amend.

- Plaintiffs argued that they overcame BJR presumption because Defendants lowered Umpqua's annual operating earnings per share goals in order to justify performance-based pay increases and didn't disclose this to shareholders (Not alleged in complaint).

- Judge held lowering goals after repeated failures to meet them in economic downturn not sufficient to rebut BJR presumption.

- Plaintiffs cited Proxy statement to show reduction of goals occurred, *i.e*., that fact was disclosed.

***Jacobs Engineering Group Inc. Consolidated Shareholder Derivative Litigation*, LASC Case No. BC454543 (Court's Ruling and Order Re: Defendants' Demurrer Mar. 6, 2012)**

1. Original Complaint filed Feb. 4, 2011, in Superior Court of California, Los Angeles (Not Robbins Geller Rudman & Dowd)

2. **Defendants**

   - 11 Directors (Including President and CEO)
   - 5 Officers: President and CEO; EVP Finance and Administration; 3 EVPs of Operations);
   - Executive compensation firm
   - Jacobs Engineering a Delaware corporation

3. **Plaintiff's Claims**: Against all individual Defendants for:

   - Breach of fiduciary duties of candor, good faith and loyalty
   - Corporate waste
   - Unjust enrichment
   - Against Frederick for aiding and abetting breaches of fiduciary duty and breach of contract.
   - Unlike in *Cincinnati Bell*, *Beazer* and *Umpqua*, breach of fiduciary duty and unjust enrichment claims asserted against both D's and O's and added waste claim.

4. <u>Company's 2010 performance was poor</u>
   a. Revenues declined from 2009 by $1.55 billion (nearly 14%)
   b. Net earnings fell by $153 million (38.5%)
      - Earnings per share fell by $1.28 (39.3%)
      - ROE fell from 16.42% in 2009 to 8.97% in 2010 (45% decline)
      - Return on invested capital fell from 16.1% to 8.9% (44% decline)

5. <u>Executive officers' comp in 2010 increased</u>
   a. CEO's total comp up 27.5% from $4.6 million to $6.4 million
      - <u>Base salary up 13.4% ($1.150M to $1.165M), but down from 25% of total to 18.3%;</u>
      - <u>Non-equity incentive plan comp decreased from $978,000 to $674,000 (31.1% decrease</u>);
      - <u>Stock and option awards increased from $2.5 to 4.5 million (80% increase</u>)

6. 53.7% of SHs on Jan. 27, 2011, rejected the Company's 2010 executive comp

7. Plaintiff's allegations re: demand futility

a. By recommending to SHs approval of pay hikes and failing to take action when SHs rejected that recommendation in light of Company's poor performance in violation of pay-for-performance policy, there is doubt that comp decisions were reasonable, loyal, made in good faith and presumptively protected business judgments. (*Aronson* 2d prong)

b. Board recommended SH approval of excessive comp. and then failed to rescind raises after failed say-on-pay vote. This demonstrated Board hostility toward relief sought by Plaintiffs. (*Aronson* 1st prong)

c. Board liable for breaches of fiduciary duty, waste and unjust enrichment and therefore disabled as matter of law from objectively considering pre-suit demand. (*Aronson* 1st prong)

8. Court sustained initial demurrer with leave to amend based on failure of Plaintiffs to plead demand futility adequately by failing to establish Defendants not disinterested; also expressed "reservations" re: sufficiency of allegations to state a claim for breach of fiduciary duty "that would not be precluded by [BJR]."
9. Plaintiffs filed amended complaint on December 12, 2011.
10. Defendants demurred again on same grounds; Court sustained demurrer without leave to amend.
11. Court mixes and matches standards:
    a. Court said under *Rales*, issue is whether particularized factual allegations create reasonable doubt that Board could have exercised independent and disinterested business judgment in response to a demand.
        - But Rales does not apply to affirmative actions of Board
12. From there, Court says, defendants must therefore meet two-prong Aronson test by showing particularized facts creating reasonable doubt that
    a. directors are disinterested in and independent of challenged transaction; or
    b. challenged transaction was the product of a valid business judgment.
13. Court got the *Aronson* test right.

Court's Decision

- 1 director received pay hike; no specific allegations that any other director was interested.
- No allegation any director signed (as opposed to issued) Proxy statement or ratified statements in it
- Dodd-Frank vote is not binding and creates no liability, so ignoring vote not enough by itself to establish liability
- Plaintiff must show conflict of interest, bad faith (fraud) or decision made without due care and due deliberation
- Standard under BJR is gross negligence.
- Plaintiffs allege Board raised pay despite poor performance and its statements in Proxy that there are consequences for underperformance, and this casts doubt on directors' loyalty and business judgment.
- Court response = SH vote advisory only. [NB: above argument not based on the vote]

Court's Decision (cont'd)

- Also pointed to statement in Proxy that directors considered survey data re: peer practices for equity awards, accounting impact on earnings, HR&C Committee's evaluations of each exec's contributions and performance.
- Court's don't second-guess business judgment of Board.
- Waste requires authorizing an exchange so one-sided no business person of ordinary, sound judgment could conclude company has received adequate consideration. No such showing.
- No breach of fiduciary duty = no aiding and abetting.
- No allegations of specific contract terms = no breach of contract claim.

Laborers' Local v. Intersil, Case No. 5:11-CV-04093 EJD (N.D. Cal. Mar. 7, 2012)

- Plaintiff claim = negative "say-on-pay" shareholder vote is evidence showing that directors failed to act in the shareholders' best interests and rebuts the presumption that the Board's decision regarding compensation is entitled to business judgment protection.

- Court looked to legislative history: The shareholder vote is meant to give shareholders "the ability to hold executives accountable, and to disapprove of misguided incentive schemes." 156 Cong. Rec. S5902-01, S5916 (2010) (statement of Sen. Jack Reed).

- Congress was explicit that the shareholder vote on executive pay is non-binding, but the Act is silent on what consideration courts should give to the shareholder vote.

- Congress must have intended for the shareholder vote to have some weight if goals of section 951 are to empower shareholders and to hold executives accountable

- Furthermore, if SH vote approving meant to have no effect whatsoever, it seems unlikely that Congress would have included a specific provision requiring such a vote.

- "This court concludes that a shareholder vote on executive compensation under the Act has substantial evidentiary weight and may be used as evidence by a court in determining whether the second prong of the Aronson test has been met."
- "Ruling only on the particular facts presented in the case before the court, where 56 percent of shareholders disapproved of Intersil's 2010 executive compensation package, the court finds that the shareholder vote alone is not enough to rebut the presumption of the business judgment rule."
- Additional facts are required

Weinberg v. Gold et al., Civ. No. JKB-11=3116 (D. Md. Mar. 12, 2012) (Biomed Realty Trust, Inc.)

1. Original Complaint filed Nov. 2, 2011 (Levi & Korsinsky LLP)
2. Defendants
   - 7 Directors (Including CEO and VP/Gen'l Counsel) - 3 make up Comp Committee
   - 5 Officers: CEO; CFO; Pres/COO; VP/Gen'l Counsel; EVP Real Estate
   - Biomed Realty Trust, Inc., Maryland corporation with principal place of business in CA
3. Plaintiff's Claims:
   - Against all individual Defendants for issuance of false and misleading Proxy under Section 14(a) of Securities Exchange Act of 1934
   - Against all directors for breach of fiduciary duty
   - Against all officers for unjust enrichment

Weinberg v. Gold et al., Civ. No. JKB-11=3116 (D. Md. Mar. 12, 2012) (Biomed Realty Trust, Inc.)

4. Facts

   a. Only fact noted in court's opinion is May 25, 2011 SH vote rejecting 2010 comp plan.

   b. Doesn't indicate percentage of vote

   c. Passing reference to company having pay-for-performance philosophy

   d. Doesn't talk about whether 2010 exec comp salaries were increased or by how much

   e. Doesn't quote a single word from the Proxy statement – alleged misrepresentations and omissions in Proxy statement indicated company had pay-for-performance policy

   f. Biomed filed motion to dismiss for failure to make demand

   g. Individual defendants filed motion to dismiss for failure to state a claim because

      - no allegations show exec comp decision was contrary to BJR
      - no allegations show materially false statement or material omission
      - no allegations show unjust enrichment

   h. Court granted Biomed's motion; denied other as moot

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***Weinberg v. Gold et al*., Civ. No. JKB-11=3116 (D. Md. Mar. 12, 2012) (Biomed Realty Trust, Inc.)**

Court's decision re: no excuse for failure to make demand

- *Werbowsky v. Collomb*, 766 A.2d 123 (Md. 2001) is controlling case
- Rejected Delaware approach under Aronson
- Unwilling to excuse demand simply because
  - majority of directors approved or participated in challenged transaction
  - general allegations they are conflicted or controlled by other conflicted persons
  - general allegations they are highly compensated as directors
  - general allegations they were chosen as directors by controlling SH
  - general allegations they are hostile to action.
- *Werbowsky* court concluded
  - "We adhere, for the time being, to the futility exception but . . .regard it as a very limited exception to be applied only when the allegations or evidence clearly demonstrate, in a very particular manner, either that

    (1) the demand, or a delay in awaiting a response to a demand, would cause irreparable harm to the corporation, or

    (2) a majority of the directors are so personally and directly conflicted or committed to the decision in dispute that they cannot reasonably be expected to respond to a demand in good faith and within the ambit of the business judgment rule."

Weinberg v. Gold et al**., Civ. No. JKB-11=3116 (D. Md. Mar. 12, 2012) (Biomed Realty Trust, Inc.)**

Weinberg Court's decision

1. Court issued order saying it was granting Biomed's motion to dismiss for failure to state a claim and dismissed the case.
2. Plaintiff's allegations that

   a. each director approved the comp plan either as member of the Comp Committee or full Board;

   b. participated in preparation of contested proxy statement; and

   c. was a named defendant

   all insufficient to establish they were so "personally and directly conflicted" that they could not reasonably be expected to consider demand in good faith and with exercise of business judgment.
3. Naming director in suit does not mean demand would have been futile prior to the suit; demand is analyzed on basis of pre-suit not post-filing circumstances.
4. Plaintiff alleged say-on-pay vote rebutted presumption of BJR and directors' issuance of allegedly false statements that exec comp based on pay-for-performance was not a valid exercise of the BJR.
5. Court said these arguments go to merits and *Werbowsky* disallows consideration of merits in analyzing demand futility.
6. Vote provided opportunity for Board to reconsider its comp decision; but it's not the equivalent of a pre-suit demand - - can produce unfavorable publicity but does not inevitably lead to lawsuit.
7. But also said that "[a]lthough a "say-on-pay vote" may be reasonably considered as a factor in the demand futility analysis, it is not conclusive in this case."

What Is A Board To Do?

1. Let 'em vote and ignore them?

   - Tempting given the litigation results to date, but not viable.

2. SEC rules require that a company disclose in its proxy statement whether and how the company took into account the say-on-pay vote in making future executive compensation decisions.

3. ISS (Institutional Shareholder Services) threshold is 70%. If 2011 vote was 70% or better:

   a. Could say that comp committee viewed the favorable vote as further validation of the company's approach and as a result no changes were made.

   b. Clearly identifying last vote was greater than 70% in favor may help in the current year's say-on-pay vote

   c. Remain cognizant of views of key institutional stockholders.

   d. Maintain an effective stockholder outreach program look for ways to improve the quality of executive compensation disclosures may help preserve high levels of stockholder support for future say-on-pay votes.

What Is A Board To Do?

4. For companies whose vote in 2011 was less than 70%:

   a. Seriously consider engaging in a proactive outreach effort with key institutional stockholders to get a sense of the principal concerns that these stockholders have with the executive compensation program.

   b. For companies with stockholders that tend to follow ISS recommendations, making changes that are likely to address ISS's concerns may be important. For companies in this category, members of the compensation committee are at increased risk of receiving "against" or "withhold" votes, adding additional incentive to take appropriate actions and presenting a descriptive and persuasive CD&A.

What Is A Board To Do?

5. General Considerations

   a. There is no fixed template for drafting the CD&A.

   b. But there are evolving best practices, such as the use of an "executive summary" and other forms of "layered disclosures" to provide easy-to-read summary information within the CD&A. Many companies are beginning to consider ways to visually display the pay-for-performance link.

   c. Say what you mean; mean what you say.

      - Do not describe a set of strict pay-for-performance metrics unless you really mean it.
      - Any description of a pay-for-performance policy should refer to the myriad of factors that are considered, including personal skill levels, advice from a compensation consultant, the compensation paid by the company's competitors, desire to retain competent and skilled managers, the economic environment, individual as well as corporate performance goals and any other relevant non-financial performance metrics (*e.g*. safety) .

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What Is A Board To Do?

5. General Considerations (cont'd)

   a. Establish a policy for dealing systematically with the impact that extraordinary events have on incentive compensation awards

   b. A compensation recoupment or clawback policy

   c. Rotating compensation committee members

   d. Clear explanations of why the compensation is what it is and how and why it complies with the company's compensation policy

   e. Hire a good lawyer