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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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BUSINESS LAW **TODAY**
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Keeping Current:
2012 Outlook for Say-on-Pay Lawsuits

By Paul R. Bessette, Royale Price, and R. Adam Swick

The say-on-pay portion of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) became effective at the beginning of 2011, and during the year we saw a rash of shareholder derivative actions based on failed say-on-pay votes. By the end of 2011, however, few courts had issued decisions on whether allegations of a failed say-on-pay vote were sufficient to survive a motion to dismiss. And, surprisingly, the few courts that did answer this question did so inconsistently. This lack of clear guidance will help make the 2012 decisions in say-on-pay lawsuits unpredictable and increase the risk associated with executive compensation decisions for directors and their executive compensation consultants.

The Dodd-Frank Say-on-Pay Requirement

Dodd-Frank requires a shareholder say-on-pay vote at least once every three years to approve a company's senior executive compensation. The say-on-pay vote, however, is advisory only, as Dodd-Frank specifically states that the vote shall not be binding on the issuer or the board of directors and may not be construed as (1) overruling a decision by an issuer or board of directors, (2) creating or changing fiduciary duties, or (3) restricting or limiting shareholder proxy access to make proposals on executive compensation.

Say-on-Pay Actions

Since the say-on-pay provision became effective at the beginning of 2011, approximately 49 companies have failed the say-on-pay vote when fewer than half of their shareholders voted in favor of the proposed executive compensation. And, despite Dodd-Frank's specific advisory provisions, approximately 35 percent of the failed votes have resulted in shareholder derivative actions, usually when the company's financial performance or stock price faltered as compensation levels rose.

Plaintiffs' firms use a failed say-on-pay vote as a basis for shareholder derivative actions, alleging that the company's board of directors breached their fiduciary duties to the shareholders by approving excessive executive pay. They use the failed say-on-pay vote to get around obstacles that have historically prevented derivative suits based on excessive executive compensation—showing demand futility and the presumption of the business judgment rule to the board's decision to increase compensation.

Recent Decisions

Five courts have issued orders or opinions in say-on-pay actions to date. The first was the Georgia Superior Court on September 15, 2011, in *Teamsters Local 237 Additional Security Benefit Fund, derivatively and on behalf of Beazer Homes USA, Inc. v. McCarthy, et al*, No. 11-197841, 2011 WL 4836230, which answered the question posed at the outset in the negative, dismissing the suit for failure to plead demand futility and failure to state a claim.

The court rejected plaintiff's arguments "as wholly unpersuasive" for two primary reasons. First, the failed say-on-pay vote occurred *after* the board voted to increase executive compensation and recommended that shareholders vote to approve that compensation. Thus, the failed vote did not suggest that the board "failed to act on an informed basis, in good faith, and in the honest belief that the decisions were in Beazer Homes's best interest" to establish demand futility or rebut the business judgment rule. Second, the court found plaintiff's contention that the "independent business judgment" of Beazer Homes's shareholders, in and of itself, was sufficient to rebut the business judgment rule presumption, was not supported by Delaware law or Dodd-Frank. The court noted that Dodd-Frank "expressly preserved the pre-existing fiduciary duty framework concerning directors' executive compensation decisions."

Also noteworthy is that the *Beazer Homes* complaint contained allegations against a compensation consultant for aiding and abetting the board's alleged breaches of fiduciary duty. The court found that when challenging the actions of a third party, as opposed to a board's, showing demand futility is even more difficult. The court held that a plaintiff must plead particularized facts sufficient to create a reasonable doubt that a majority of Beazer Homes's directors could have exercised independent and disinterested business judgment in responding to the demand to sue the compensation consultant. In other words, plaintiffs must show a lack of independence and disinterestedness as to the third party; they cannot merely rely on showing a violation of the business judgment rule.

Shortly after the *Beazer Homes* ruling, on September 20, 2011, the Southern District of Ohio issued its ruling in *NECA-IBEW Pension Fund, derivatively on behalf of Cincinnati Bell, Inc. v. Cox, et al.*, No. 11-451, 2011 WL 4383368, and answered the question the other way. Applying Ohio law, the court found that the plaintiff's "factual allegations raise a plausible claim that the multi-million dollar bonuses approved by the directors while the company experienced 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." Important to the court's holding was that under Ohio law, the business judgment rule "imposes a burden of proof, not a burden of pleading," and therefore the plaintiff's allegations that the failed say-on-pay vote rebuts the business judgment rule was sufficient for the case to proceed.

In holding that the *Cincinnati Bell* plaintiffs stated a claim for breach of fiduciary duty, the court also concluded that a pre-suit demand on the board would have been futile. Ohio law requires a plaintiff to point to facts establishing that the board was unable to make "unbiased, independent business judgments about whether to sue" on behalf of the company. The court held that the plaintiff established demand futility because the directors who would have considered the demand were the same ones who approved the increased pay and bonuses, and who recommended that the shareholders do the same, and therefore there was reason to doubt whether the directors could exercise their independent business judgment over whether to sue themselves.

Next, on November 10, 2011, the Los Angeles County Superior Court issued a minute order in the *Jacobs Engineering Group, Inc. Consolidated Shareholder Derivative Litigation*, No. BC454543, dismissing the breach of fiduciary duty claim against the director defendants and the company's compensation consultant "based on deficiencies in the underlying claims against the individual defendants." The court did not issue a full opinion.

Then, on January 6, 2012, the Southern District of California denied plaintiff's request for a declaratory judgment that the failed PICO Holdings, Inc., shareholder say-on-pay vote rebutted the business judgment surrounding the board's decision to increase 2010 executive compensation in *Dennis v. Hart*, Case No. 11cv2271 WQH, 2012 WL 33199. Relying on Dodd-Frank's explicit mandate that it may not be construed to create new or change existing fiduciary duties, the court held that the plaintiff failed to state a claim for declaratory judgment. The court further remanded the case to the San Diego County Superior Court, where it was originally filed before defendants removed it to federal court for further proceedings.

Finally, on January 11, 2012, a federal magistrate judge in the District of Oregon issued its findings and recommendations in *Plumbers Local No. 173 v. Davis*, Civ. No. 03:11-633-AC, 2012 WL 104776. The magistrate judge looked to Delaware law for guidance and expressly agreed with *Beazer Homes*, but limited the holding to finding that plaintiffs failed to plead that demand on the Umpqua Holdings Corp. board would have been futile, and did not reach the merits of the claims. The magistrate judge also considered the holding in *Cincinnati Bell*, but disregarded it stating that "it is unlikely that the case remains viable legal authority." The plaintiffs objected to the magistrate's decision, and as of the date of publication the district judge had not issued its opinion accepting or rejecting the magistrate judge's findings and recommendations.

Implications of the Say-on-Pay Decisions

It was difficult to reconcile the starkly contrasting holdings in *Beazer Homes* and *Cincinnati Bell* after they were issued in late September 2011. One possible explanation for the divergence was that *Beazer Homes* was decided under Delaware law, while *Cincinnati Bell* was decided under Ohio law. According to *Cincinnati Bell*, which commentators highly criticized, the Ohio version of the business judgment rule does not require a plaintiff to plead operative facts in a complaint that would rebut the presumption that informed decisions on compensation are the product of valid business judgment. According to the *Cincinnati Bell* court, "the business judgment rule imposes a burden of proof, not a burden of pleading." Under the Delaware rule, on the other hand, which many jurisdictions outside of Delaware also follow, a complaint will not survive a motion to dismiss unless it contains "particularized facts sufficient to create a reasonable doubt that either (1) the directors were not disinterested and independent, or (2) the challenged transaction was not the product of a valid exercise of business judgment."

Perhaps, as the District of Oregon magistrate judge noted, *Cincinnati Bell* was wrongly decided. Dodd-Frank's express language and Delaware law strongly suggest that a failed say-on-pay vote should not affect excessive compensation derivative suits. Shareholders will no doubt continue to cite *Cincinnati Bell* in support of their arguments, and the contrasting holdings in *Cincinnati Bell* and *Beazer Homes* may create some confusion for other say-on-pay cases in the near future. Courts will struggle to reconcile the two holdings and the outcome will be somewhat unpredictable. The more recent orders in the *Jacobs Engineering*, *PICO Holdings*, and *Umpqua Holdings* actions, however, suggest how future courts might answer the question. But, until the legal authority in this new area of law is more definitive, companies should be cautious when approving increased executive compensation while their financial results or stock price are lagging. Should shareholders vote against the executive compensation, even though the vote is advisory only, a derivative action challenging the compensation is very possible.

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