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Early Feedback on the Viability of "Say-on-Pay" Derivative Litigation: Two Courts Are Divided

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During the 2011 proxy season, which is drawing to a close, thirty-eight companies have failed to receive majority shareholder votes in support of their executive compensation "say-on-pay" proposals. Not surprisingly, plaintiffs' lawyers quickly began filing derivative suits alleging that the directors of companies with failed "say-on-pay" votes breached their fiduciary duties by approving excessive compensation and that the recipients of the compensation were unjustly enriched. Exhibit A offered in support of these claims is the negative "say-on-pay" votes. Few commentators expected an adverse shareholder vote to give rise to a claim or to be a sufficient basis to overcome the protections of the business judgment rule in light of Congress' express instruction that the shareholder vote is not to be construed: (1) as overruling a decision by the company or its board of directors; (2) to create or imply any change to the fiduciary duties of such company or its board of directors; (3) to create or imply any additional fiduciary duties for the company or its 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. 15 U.S.C. § 78n-1(c).

So far, the commentators have only been half right. Two courts recently decided motions to dismiss "say-on-pay" derivative lawsuits and have reached dramatically different conclusions regarding the import of a negative shareholder vote, albeit under different state laws.

Teamsters Local 237 Additional Security Benefit Fund v. McCarthy (Beazer Homes)

Beazer Homes was one of the first companies to experience a negative "say-on-pay" vote by its shareholders. 54 percent of the voted shares voted against the company's "say-on-pay" resolution (not counting abstentions and uninstructed shares voted by brokers on other matters).

A shareholder filed a derivative action in Georgia state court shortly after the negative "say-on-pay" vote. According to the plaintiff, the Board of Directors of Beazer Homes approved pay increases for its top four executives in 2010, including an increase of 7.2 percent in total compensation for the company's CEO. In the same year, Beazer Homes had suffered a net loss of $34 million and a decline in annual share price of more than 17 percent as a result of the collapse of the housing market. The plaintiff alleged that the directors of Beazer Homes breached their fiduciary duties by approving "excessive" executive pay for 2010, by recommending that shareholders vote to approve the executives' compensation, and by not rescinding the compensation program following the negative "say-on-pay" vote. The plaintiff also alleged that the

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company's compensation consultant breached its contract with Beazer Homes and aided and abetted the directors' breaches of fiduciary duty.

The defendants and the company moved to dismiss the complaint arguing that, under Delaware law, the shareholder plaintiff failed to plead demand futility and that the complaint did not allege particularized facts sufficient to rebut the business judgment presumption. The Georgia Superior Court agreed and dismissed the suit. *Teamsters Local 237 Additional Security Benefit Fund v. McCarthy*, No. 2011-CV-197841, 2011 BL 272332 (Ga. Super. Fulton County Sept. 15, 2011).

Applying Delaware law, the court first considered whether the plaintiff was required to make a pre-suit demand on the Board of Directors. Specifically, the court examined whether the complaint alleged particularized facts raising a reasonable doubt that either: (1) a majority of the board was disinterested, or (2) the challenged decision was the result of a valid exercise of business judgment. The court concluded that the plaintiff had not raised a reasonable doubt that a majority of the board was disinterested–only one member of the seven-member board (the company's CEO) received the challenged compensation and the plaintiff did not allege that the insider controlled the other board members. The mere fact that the director defendants had approved the challenged compensation was not sufficient to establish that the board could not faithfully evaluate a litigation demand.

The court also held that the plaintiff's allegations did not raise a reasonable doubt that the compensation decisions were the product of valid business judgments. Under Delaware law, directors have "wide discretion" to set executive compensation and such judgments are usually entitled to business judgment protection. The court rejected the plaintiff's assertion that the adverse "say-on-pay" vote rebutted the presumption that the directors' decisions–made before the shareholder vote–reflected the directors' valid business judgment. Because the "say-on-pay" vote had not yet been held when the challenged decisions were initially made, the directors could not have taken the shareholders' views into account when making those decisions. According to the court, such "[h]indsight second-guessing and Monday morning quarterbacking of the sort Plaintiffs urge are fundamentally inconsistent with the business judgment analysis." Moreover, the court held, the Dodd-Frank Act expressly directs that the "say-on-pay" vote is not binding and creates no change to directors' fiduciary duties. Thus, the directors were also under no obligation to rescind the executives' compensation, as the plaintiff contended.

The court additionally held that even if the plaintiff had adequately pled demand futility, the complaint still should be dismissed because the plaintiff failed to state a claim for relief. No facts were alleged to justify departure from the business judgment rule, nor did the complaint allege any specific facts that would establish the directors misled shareholders regarding the company's pay-for-performance compensation policy. Absent an underlying breach of fiduciary duty, the court also dismissed the claims against the company's compensation consultants, PricewaterhouseCoopers and Markson HRC.

NECA-IBEW Pension Fund v. Cox (Cincinnati Bell)

Within days after the *Beazer Homes* decision, the United States District Court for the Southern District of Ohio reached exactly the opposite result applying Ohio law, declining to dismiss a similar "say-on-pay" derivative action filed by a union pension plan on behalf of shareholders of Cincinnati Bell, Inc. *NECA-IBEW Pension Fund v. Cox*, No. 11-CV-451, 2011 BL 272333 (S.D. Ohio Sept. 20, 2011).

As required by Dodd-Frank, Cincinnati Bell included a shareholder resolution in its 2011 annual proxy seeking shareholder approval for increased executive compensation. The shareholders expressed strong disapproval of the increases, with 66 percent of the voted shares voting against the proposed resolution.

This vote also prompted a shareholder derivative action. According to the shareholder plaintiff, Cincinnati Bell's Board of Directors approved substantial increases in compensation for its top three executives of 71.1 percent, 80.3 percent, and 54.3 percent for 2010, the same year that the company suffered a $61 million decline in net income, a drop in earnings per share, and a negative shareholder return of almost 19 percent. The plaintiff alleged that Cincinnati Bell's directors breached their fiduciary duties by approving, and by recommending that shareholders also vote to approve, these substantial executive pay increases despite the company's "dismal" performance in 2010. The plaintiff also alleged claims for unjust enrichment, and against the company's executive compensation consultant, Towers Watson & Co., a claim of aiding and abetting the directors' breaches of fiduciary duty.

The defendants filed a motion to dismiss the complaint, arguing that the plaintiff failed to present a pre-suit demand to the board and failed to allege that demand was futile, as required by law in Ohio, the state of Cincinnati Bell's incorporation. The defendants also argued that even if demand was excused, the business judgment rule required dismissal of the complaint because the plaintiff did not plead specific facts that, if proven, would establish the directors' conduct was not the product of their valid business judgment. The district court rejected the defendants' arguments and denied the motion to dismiss.

Applying Ohio law regarding the business judgment presumption, the district court held that the plaintiff's allegations were sufficient 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," were not in the shareholders' best interests, and constituted an abuse of discretion or bad faith. In reaching this conclusion, the court identified the plaintiff's allegations that compensation of the company's top three executives had increased substantially–in excess of 50 percent year-over-year–during a year in which the company's performance had suffered. The court also expressly noted that the negative shareholder advisory vote on executive compensation provided "direct and probative evidence that the 2010 executive compensation was not in the best interests of the Cincinnati Bell shareholders." The court emphasized that the plaintiff was not required to plead with particularity facts sufficient to rebut

the business judgment rule. The court then acknowledged that "[d]efendants may offer the affirmative defense of the business judgment rule at trial" or summary judgment, but determined that dismissal on this ground was not warranted.

The district court also rejected the defendants' contention that the plaintiff failed to plead demand futility. The district court noted that under Ohio law, demand is presumptively futile when the directors are involved in the challenged transaction. Applying this principle, the district court reasoned that demand was futile "[g]iven that the director defendants devised the challenged compensation, approved the compensation, recommended shareholder approval of the compensation, and suffered a negative shareholder vote on the compensation . . . ."

The court also refused to dismiss the plaintiff's unjust enrichment claim, holding that the three top executives may have been unjustly enriched as a result of the directors' alleged breaches of fiduciary duty even though they rendered valuable services to Cincinnati Bell.

Notably, while the district court denied the defendants' motion to dismiss, it also denied the plaintiff's application for a preliminary injunction. The plaintiff sought to enjoin Cincinnati Bell's Board from effectuating the 2010 executive compensation plan and placing the increased compensation into a constructive trust. *NECA-IBEW Pension Fund v. Cox*, No. 11-CV-00451 (S.D. Ohio Sept. 26, 2011). The district court concluded that the plaintiff had not satisfied the heightened showing necessary for preliminary injunctive relief, nor established that any loss could not be fully remedied by monetary damages.

Analysis

The conflicting *McCarthy* and *Cox* decisions are just the opening salvo and do not provide unequivocal direction to courts and litigants currently grappling with "say-on-pay" derivative litigation. Guidance from other courts is necessary before a clear framework for analyzing and disposing of these cases will emerge. But a few unmistakable principles emerge from these cases that will be highly relevant to the process of "say-on-pay" derivative litigation.

First, the *Cox* court's refusal to dismiss the plaintiff's complaint is likely to embolden plaintiffs' lawyers to pursue "say-on-pay" claims against directors of other companies with failed "say-on-pay" votes. Thus far, fewer than ten of the companies with failed "say-on-pay" votes during 2011 have been named in shareholder suits. The *Cox* ruling makes it highly likely that additional lawsuits will be filed by shareholders of other companies with negative "say-on-pay" votes.

Second, the outcome of these cases may depend substantially upon the applicable law. This was a critical difference in the divergent outcomes of the *Cox* and *McCarthy* cases. In *McCarthy*, the court's application of established Delaware demand futility pleading principles led to the conclusion that the plaintiff had not overcome that state's relatively high standards. Courts applying Delaware law seem unlikely to depart from the *McCarthy* court's reasoning. Indeed, recent authority applying Delaware law reaffirms the Delaware courts' strongly-held view that "[t]he decision as to how much compensation is appropriate to retain and incentivize employees . . . is a core function of a board of directors exercising its business judgment." *In re Goldman Sachs Group, Inc. Shareholder Litigation*, No. 5215, slip. op. at 38, 2011 BL 262738 (Del. Ch. Oct. 12, 2011). In contrast, the less stringent requirements of Ohio law enabled the plaintiff in *Cox* to survive the pleading stages.

Third, the fact patterns of the "say-on-pay" cases of the companies with failed say-on-pay votes in 2011 that triggered lawsuits and those that have not provide few clues as to which companies will be sued and which will not. The few clues these cases do provide relate less to the companies' pay practices and more to the composition of their shareholders. But it is very clear that the possibility of derivative litigation will put even more pressure on public companies to pass their say-on-pay votes in 2012 than in 2011.

Fourth, it is clear from the vast majority of the 2011 failed say-on-pay vote cases, as well as the litigated cases, that negative vote recommendations made by proxy advisers such as Institutional Shareholder Services, Glass Lewis and others on the basis of alleged "pay-for-performance disconnects" were a major driving force. This fact and the fact that the SEC is expected to issue rules by year-end requiring companies to disclose the relationship between the compensation they have paid their named executive officers and the company's financial performance (so-called "pay-versus-performance" under 15 U.S.C. § 78n-(i)) in narrative and likely graphic form makes it imperative that companies understand and deal with pay-for-performance issues in designing, analyzing and describing their pay plans in 2012. In this regard, the *McCarthy* and *Cox* decisions suggest that the perceived magnitude of the executive compensation increase and alleged pay-for-performance disconnect matter. While Beazer Homes' directors increased executives' compensation in 2010 despite poor corporate performance, the increase in compensation for the company's CEO was relatively modest, at just over 7 percent year-over-year. By comparison, the increases for Cincinnati Bell's top executives were dramatic, with alleged increases in total compensation in 2010 of 71.1 percent, 80.3 percent, and 54.3 percent year-over-year. The court's introductory paragraph in the *Cox* opinion strongly suggests that these alleged substantial increases were material to the court's analysis; what is less clear, and what will hopefully be demonstrated as the case is litigated is that a snapshot of executive pay opportunities awarded in 2010, using Black-Scholes grant date values for equity and other long-term incentive compensation awards, indicates a future pay opportunity, not actual pay, and is a poor way of analyzing whether actual pay during the prior periods of alleged poor company financial performance was in fact disconnected from that performance.

The *McCarthy* and *Cox* decisions are only the first of presumably many addressing "say-on-pay" shareholder votes. Many issues remain to be decided including what evidence might rebut the business judgment rule at the summary judgment or trial stages and what the impact will be of subsequent "say-on-pay" votes in next year's proxy season.