U.S. District Court Refuses to Grant Motion to Dismiss in "Say-on-Pay" Lawsuit

Since January 2011, reporting companies have been required to afford shareholders the opportunity to vote, at least once every three calendar years, on resolutions regarding the compensation of the companies' named executive officers ("NEOs"), as disclosed in the companies' annual proxy statements ("say-on-pay").[1] This say-on-pay vote is required pursuant to Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and the final rules promulgated by the Securities and Exchange Commission ("SEC") which implement Section 951 of the Dodd-Frank Act (collectively, "say-on-pay rules").[2] The language of the say-on-pay rules makes clear that such votes are merely advisory; they are "not ... binding on the issuer or the board of directors of an issuer, and may not be construed ... as overruling a decision by such issuer or board of directors." In addition, the say-on-pay rules state that the say-on-pay vote "may not be construed ... to create or imply any change to the fiduciary duties of such issuer or board of directors ... [or] to create or imply any additional fiduciary duties for such issuer or board of directors."

Despite the seemingly unambiguous language of the say-on-pay rules, shareholders have filed derivative suits in the wake of negative say-on-pay votes at several companies, including Beazer Homes USA, Inc., Cincinnati Bell Inc., Dex One Corporation, Hercules Offshore, Inc., Jacobs Engineering Group Inc., Janus Capital Group Inc., KeyCorp, Occidental Petroleum Corporation and Umpqua Holdings Corporation.[3] The defendant companies targeted by such lawsuits have generally shared some important commonalities, including: (1) a compensation policy that purports to link a significant portion of the executives' total compensation to the financial performance of the company and shareholder returns ("pay-for-performance"), (2) a decision by the board of directors to increase executive compensation in spite of declining corporate financial performance and stock price, (3) a negative say-on-pay vote from shareholders, and (4) an ensuing failure by the board to modify or rescind the executive compensation packages.

The complaints in say-on-pay shareholder derivative actions have generally alleged the following causes of action:

- *Breach of the fiduciary duties of care and loyalty* to the shareholders by the company's directors and officers for approving an excessive executive compensation plan;

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[1] Smaller reporting companies with a public float of less than $75 million are not required to conduct say-on-pay votes until annual meetings occurring on or after January 21, 2013.

[2] The Dodd-Frank Act is available at http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173. Section 951 of the Dodd-Frank Act added Section 14A to the Securities Exchange Act of 1934. Section 14A requires companies to conduct separate shareholder advisory votes regarding say-on-pay, the frequency of conducting say-on-pay votes and compensation arrangements in connection with significant corporate transactions, such as mergers, acquisitions, consolidations, asset sales, going private transactions and third party tender offers. The SEC final rules concerning shareholder advisory votes are available at http://www.sec.gov/rules/final/2011/33-9178.pdf. For further discussion of the SEC rules and say-on-pay generally, *see* our firm memorandum, SEC Adopts Final Rules Regarding Shareholder Approval of Executive and Golden Parachute Compensation (Feb. 1, 2011), *available at* http://www.cahill.com/news/memoranda/100264/_res/id=sa_File1/CGR%20Memo%20-%20SEC%20Adopts%20Final%20Rules%20Regarding%20Shareholder%20Approval%20of%20Executive%20and%20Golden%20Parachute%20Compensation.pdf.

[3] The same five plaintiff firms have filed all of the roughly ten say-on-pay shareholder derivative suits filed to date. These firms include Barrack, Rodos & Bacine, Landskroner; Grieco & Madden, LLC, Robbins Geller Rudman & Dowd LLP, Strauss & Troy and The Weiser Law Firm, P.C.

- *Aiding and abetting* of this breach of fiduciary duty by the compensation consultants insofar as they provided recommendations to the board that were unreasonable and made in bad faith in order to increase executive compensation in spite of declining financial performance by the company;[4]

- *Breach of contract* by the compensation consultants for failing to provide "competent and sound" advice and services;

- *Unjust enrichment* by the company's directors who are also NEOs insofar as they have unjustly benefited from the pay increases;[5]

- *Corporate waste* by the directors insofar as they approved executive compensation plans that caused the company to squander corporate assets; and

- *Misrepresentation* by the directors in SEC filings that the company had a "pay-for-performance" policy when, in fact, the board was willing to increase executive compensation regardless of poor financial performance by the company.

The plaintiffs in these actions have sought recovery from the defendants of the allegedly excessive compensation that was awarded to the executives. They have also demanded that internal controls be implemented in order to restrict the payment of excessive executive compensation to the NEOs at these companies in the future.

Typically, a board's decision regarding executive compensation is protected by the business judgment rule. The business judgment rule is a judicial presumption that the directors "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[6] Rebutting this presumption has traditionally been difficult for plaintiffs in shareholder derivative suits. Thus, it came as no surprise when the first court to tackle a say-on-pay shareholder derivative lawsuit—a Georgia state court—dismissed the suit against the defendant board of Beazer Homes earlier this year.[7]

Many legal scholars expected the same result in other say-on-pay suits. Surprisingly, however, on September 20, 2011, a federal district court judge in the Southern District of Ohio allowed the shareholder plaintiff to survive a motion to dismiss in a suit against Cincinnati Bell.[8] The plaintiff in the case, the NECA-IBEW Pension Fund, alleged that the company's directors breached their fiduciary duty of loyalty when they approved pay increases of 54% to 80% for top executives, despite the fact that the company had incurred a $61.3 million decline in net income, a drop in earnings per share from $0.37 to $0.09, a reduction in share price from

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4 In addition to officers and directors, several suits have also named compensation consulting firms as defendants.

5 In the complaint involving Hercules Offshore, Inc., the NEOs who were not directors were also sued on an unjust enrichment theory.

6 *See, e.g.*, *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). In addition, before a shareholder derivative case may proceed in court, plaintiffs must usually first (1) make demand on the board of directors to consider the claims asserted in the complaint and bring a lawsuit against themselves or (2) show that making such a demand would have been futile.

7 *See Teamsters Local 237 Additional Security Benefit Fund and Teamsters Local 237 Supplemental Fund for Housing Authority Employees v. McCarthy*, Case No. 2011CV197841 (Superior Ct., Fulton County, Georgia) for a copy of the complaint filed in this case. The ruling in the case was oral, and there is no written decision.

8 *See NECA-IBEW Pension Fund v. Cox*, No. 1:11-cv-451 (S.D. Ohio Sept. 20, 2011), *available at* http://www.fedseclaw.com/uploads/file/CINCINNATI%20BELL%202011%209%2020%20Opinion%20Denying%20Motion%20to%20Dismiss.pdf. This is the first reported decision in a say-on-pay shareholder derivative lawsuit.

$3.45 to $2.80, and a negative 18.8% annual shareholder return. The plaintiff used the fact that two-thirds of voting shareholders had voted against the executive compensation plan at the company's annual meeting in May 2011 as evidence that the plan was excessive.

Although Cincinnati Bell argued that the board's decisions regarding executive compensation were protected by the business judgment rule and the case should be dismissed, the court found that the company's ability to rely on the business judgment rule was a question for summary judgment or trial. The court stated that while the defendants may attempt to rely on the business judgment rule in seeking summary judgment or at trial, they could not rely on it as a basis for dismissal. The court did note, however, that Ohio courts follow the business judgment rule[9] and, under Ohio law, directors will only face liability if a plaintiff can show by clear and convincing evidence that the board's actions were undertaken with "a deliberate intent to cause injury to the corporation" or "reckless disregard for the best interests of the corporation."[10] The court adopted the plaintiff's argument that the negative say-on-pay vote provided "direct and probative evidence that the 2010 executive compensation was not in the best interests of the Cincinnati Bell shareholders" and further opined that the negative say-on-pay vote could be used as evidence to support a claim that the directors had breached their fiduciary duty of loyalty.[11] Interestingly, the court also held that because the plaintiff had successfully pled facts for breach of fiduciary duty, it was "axiomatic" that the plaintiff had also sufficiently pled a claim for unjust enrichment.[12]

As a result of this decision, plaintiffs' attorneys may be emboldened to bring more shareholder derivative suits against companies that suffer negative say-on-pay votes, and defendant companies may have a more difficult time defending such suits. Because of the heightened litigation risks which companies now face as a result of this decision, it is more important than ever for companies to prepare diligently for say-on-pay votes. Although there is no way to guarantee an affirmative say-on-pay vote, companies can take certain actions to make approval more likely, including:

- Engaging in frequent outreach and communication with shareholders, particularly large shareholders, to understand their views and address their concerns regarding executive compensation packages;

- Reviewing and modifying executive compensation policies and practices that might otherwise cause shareholder advisory firms to recommend a negative vote; and

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9 Cincinnati is in the Sixth Federal Circuit. In *NECA-IBEW Pension Fund*, Judge Black applied the Sixth Circuit's interpretation of the "business judgment rule" and noted that courts "will not inquire into the wisdom of actions taken by a director in the absence of fraud, bad faith, or abuse of discretion." *Radol v. Thomas*, 772 F.2d 244, 257 (6th Cir. 1987).

10 Ohio Rev. Code Ann. §1701.59(D) (2011).

11 In footnote 1 of the opinion, Judge Black noted that although the language of the Dodd-Frank Act states that say-on-pay votes are non-binding and do not alter the fiduciary duties of directors, "some commentators opine that '[a] negative say-on-pay vote gives the court evidence that there's been a breach of duty. It doesn't mean there's been a breach of duty, but it can support a finding of breach.'"

12 The court further concluded that making a pre-suit demand on the board would have been futile and refused to dismiss the case on the ground that the plaintiff had failed to do so. In his ruling, Judge Black stated that, "Given 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, plaintiff has demonstrated sufficient facts to show that there is reason to doubt these same directors could exercise their independent business judgment over whether to bring suit against themselves for breach of fiduciary duty in awarding the challenged compensation."

- Providing clear and thorough disclosure in the proxy statement regarding the board's decisions related to executive compensation.[13] Companies would also be well-advised to carefully prepare the discussion of executive compensation in their proxy statements. In the say-for-pay shareholder derivative suits that have been filed thus far, plaintiffs have often tried to argue that the board's decision to increase executive compensation despite declining corporate economic performance renders the statements in the proxy statement regarding the company's pay-for-performance policy false and misleading.[14] They have also argued that boards have breached their fiduciary duties by approving executive compensatory packages that were inconsistent with the company's pay-for-performance policy as disclosed in the proxy statement. Companies should therefore take care in their proxy statements to accurately describe whether pay-for-performance is at the core of the company's compensation policy or whether it is one factor among many that is considered when the board makes compensation decisions.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Abigail Darwin at 212.701.3240 or adarwin@cahill.com.

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13 Commencing with the 2012 proxy season, reporting companies will also be required to disclose in the CD&A section of their proxy statements whether they have considered the results of the most recent say-on-pay vote, and if so, how that consideration affected the company's decisions and policies regarding executive compensation.

14 This argument may be easier to make once the SEC adopts rules to implement Section 953(a) of the Dodd-Frank Act, which requires reporting companies to include information in their proxy statements "that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions." The SEC currently plans to issue the proposed rules before December 31, 2011, but adoption of the final rules is not expected until sometime between January and June 2012. Therefore, these rules are unlikely to be applicable until after the 2012 proxy season.