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Directors' and Officers' Liability:

Say-on-Pay Shareholder Litigation Yields Mixed Results

JOSEPH M. MCLAUGHLIN*
SIMPSON THACHER & BARTLETT LLP

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Earlier this year, the Securities and Exchange Commission adopted final rules implementing the shareholder advisory votes on executive compensation mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act and applicable to most domestic public companies. Approximately 98 percent of the more than 2,300 non-binding say-on-pay votes occurring in the 2011 proxy season secured shareholder approval. In instances where a majority of shareholders have voted against their company's say-on-pay resolutions, however, a putative shareholder derivative lawsuit against the Board of Directors and any compensation advisory firm retained by the company has often followed.

Last month, a Georgia state court and an Ohio federal court issued the first two decisions addressing motions to dismiss shareholder derivative complaints based on negative say-on-pay votes, and the courts reached different conclusions. This column assesses the validity of these suits in light of Dodd-Frank, and recommends steps to mitigate the litigation and reputational risks of a negative say-on-pay vote.

Shareholder Advisory Votes

SEC Rule 14a-21(a) implements Dodd-Frank section 951's requirement that SEC-registered issuers provide shareholders at least once every three calendar years with a separate non-binding say-on-pay vote regarding the compensation of the company's named executive officers, as defined in Item 402(a)(3) of Regulation S-K—the CEO, CFO and the company's three other most highly compensated officers. Rule 14a-21(a) specifies that the advisory vote is required only when proxies are solicited at an annual or other meeting of shareholders for which the SEC's proxy solicitation rules require compensation disclosure. The company thereafter must include a statement in the Compensation Discussion and Analysis (CD&A) of the

* ***Joseph M. McLaughlin*** *is a partner at Simpson Thacher & Bartlett LLP.*

proxy statement whether and, if so, how its compensation policies and decisions have taken into account the results of the most recent shareholder say-on-pay vote.

The SEC noted in its final rule release that while mandatory CD&A disclosure is limited to company consideration of the results of the most recent say-on-pay vote, consideration of the results of earlier say-on-pay votes should be addressed if material to compensation policies and decisions. "Smaller reporting companies" (generally those having a public float under $75 million) are not required to hold say-on-pay votes until their first annual meeting on or after Jan. 21, 2013. A company currently subject to TARP say-on-pay requirements does not need to satisfy the SEC's say-on-pay requirements described until its first annual (or special meeting in lieu thereof) meeting after all of its TARP debt is repaid.

The rule does not require particular language for say-on-pay resolutions, but the company must indicate that the shareholder say-on-pay vote is to approve any executive compensation disclosed pursuant to Item 402 of Regulation S-K. The compensation of company directors is not subject to a shareholder advisory vote. And if a company makes disclosure under Item 402(s) of Regulation S-K regarding its compensation policies and practices as they relate to risk management and risk-taking incentives, those policies and practices are not subject to a shareholder advisory vote, as they relate to the issuer's compensation for employees generally.

Rule 14a-21(b) implements Dodd-Frank section 951's separate requirement that SEC-registered issuers provide shareholders at least once every six calendar years with a non-binding vote regarding the frequency of the say-on-pay vote. In the frequency vote, shareholders must be given the ability to provide an advisory vote on whether the company's say-on-pay vote "will occur every 1, 2, or 3 years." To facilitate "say on frequency" voting, the rule provides that proxy cards provided by management to shareholders must include four choices for the say-on-frequency vote: every one year, every two years, every three years or abstain.

Companies may vote uninstructed proxy cards in accordance with management's recommendation for the frequency vote only if the issuer (1) includes a recommendation for the frequency of say-on-pay votes in the proxy statement, (2) permits abstention on the proxy card, and (3) includes language in bold on the proxy card regarding how uninstructed shares will be voted. The company must disclose on Form 8-K its decision on the frequency of say-on-pay votes following each shareholder vote on the frequency of say-on-pay votes. The disclosure must be made no later than 150 calendar days after the meeting in which the frequency vote took place, and no later than 60 calendar days before the deadline for submission of shareholder proposals for the subsequent annual meeting.

'No' Votes on Pay

Significantly, section 951(c) of the Dodd-Frank Act expressly provided not only that the shareholder vote is non-binding, but also that a negative shareholder say-on-pay vote may not be construed to (i) create or imply any change in directors' fiduciary duties, or (ii) create or imply any additional director fiduciary duties. Emphasizing the advisory nature of say-on-pay votes, the SEC Office of Investor Education and Advocacy stated in a March 2011 Investor Bulletin that "[i]t is up to the company's board of directors to determine what it considers to be the best compensation policies and practices for the company."[1]

Such votes, the Bulletin continued, "do not require the company or its board of directors to take a specific action. The company's board of directors may consider advisory votes and may follow up with other communications or dialogue with shareholders as part of its deliberative process in making policy decisions." Nevertheless, in several instances in which a majority of shareholders have voted in say-on-pay votes not to approve executive compensation authorized by the board, putative shareholder derivative complaints have been filed against the members of the board and any compensation consultant retained by the company.

Citing the adverse shareholder say-on-pay vote, these complaints generally have alleged that: (i) the board breached its fiduciary duty of loyalty by approving executive compensation not in the best interests of shareholders and (where applicable) not in conformity with written company pay-for-performance policies; (ii) any executive compensation consultant retained by the company aided and abetted the breach; and (iii) any recipient of the compensation was unjustly enriched.

In *Teamsters Local 237 v. McCarthy*,[2] a Georgia state court applying Delaware law dismissed a shareholder derivative suit because, among other things, a negative say-on-pay vote failed to create a reasonable doubt that the challenged compensation decisions were valid exercises of business judgment. Plaintiff's central allegation was that the Board of Beazer Homes acted disloyally by approving 2010 executive pay challenged as "excessive" in view of the company's 2010 net losses, which were behind industry averages. The rejection of the executive pay by a majority of shareholders, plaintiff asserted, rebutted the business judgment rule's presumption that the board's compensation decisions were proper exercises of discretion.

As a threshold matter, the court concluded the claims were barred by the contemporaneous and continuous stock ownership requirements because the plaintiff alleged it owned company stock only since May 2010, while the challenged board determinations regarding executive compensation were made before that time. In addition, plaintiff's failure to make pre-suit demand on the board was not excused as futile because a majority of the directors were disinterested and independent as to the compensation decision, i.e., they were neither recipients of such compensation nor under the control of the recipients.

Noting the substantial discretion Delaware substantive law affords directors on executive compensation matters, the court recognized that Dodd-Frank preserved that discretion and specifically made say-on-pay votes non-binding. In the absence of particularized allegations showing a majority of the directors acted disloyally, the court concluded that the negative shareholder vote "did not require that the challenged pay be rescinded and [did] not support a reasoned inference that any alleged failure to do so was not a valid business judgment." Stated simply, "the outcome of the vote, which was not known when the challenged decisions were made, [did] not suggest" that the board acted disloyally.

Five days later, an Ohio federal court applying Ohio substantive law reached the opposite conclusion in *NECA-IBEW Pension Fund v. Cox*.[3] The court ruled that pre-suit demand was excused and declined to dismiss a derivative suit against the Board of Cincinnati Bell brought after 66 percent of the company's voting shareholders voted against the 2010 executive compensation package. Plaintiff alleged that the negative shareholder vote was evidence that the board's decision to approve 54 percent to 83 percent increases to senior executives' pay, despite a $63 million decline in the company's net income and a negative annual shareholder return of 18 percent, was not in the best interests of shareholders, and incompatible with the company's express pay-for-performance compensation policies.

The court framed the issue as "whether a shareholder of a public company may sue its directors [derivatively] for breach of the duty of loyalty" in granting bonuses and other compensation to senior executives in a year in which the company's income, earnings and stock price suffered significant declines. Reasoning that the shareholder vote supported "a plausible claim that the multi-million dollar bonuses approved…in a time of the company's declining financial performance violated [its] pay-for-performance compensation policy and were not" in the shareholders' best interests, the court denied the board's motion to dismiss. The court acknowledged the established principle that "[i]nformed decisions on compensation rendered by disinterested directors are presumed to be the product of a valid business judgment," but accepted plaintiff's argument that the shareholder vote presented "direct and probative" evidence sufficient to overcome the presumption.

The court also acknowledged but declined to enforce the established principle that the mere fact that directors are asked to sue themselves is insufficient to excuse demand (otherwise demand routinely would be excused regardless of whether particularized facts supported the allegations against directors). Demand was excused, the court concluded, because directors were "the very same people who approved the pay hikes and bonuses, and plaintiff…named all directors who approved the compensation asdefendants."

Not only did the directors approve the transaction, the court continued, "they also recommended to the shareholders that the shareholders approve the compensation." Accordingly, where the directors "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."

Conclusion

Delaware law has long recognized that when it comes to decisions on executive compensation, the business judgment rule affords directors great deference. It is the essence of business judgment for a board to determine the value of an individual's service to the company, whether in the form of current salary, bonus or severance. Dodd-Frank's say-on-pay provisions expressly recognized and preserved that deference, specifically determining that (i) the vote requirements did not alter existing fiduciary duties or create new ones, and (ii) shareholder say-on-pay votes are non-binding, advisory-only.

The board and its compensation committee do not have the benefit of the say-on-pay vote until after the executive compensation is considered and approved. In these circumstances, an adverse shareholder vote ordinarily will add little to judicial consideration of whether a plaintiff can overcome the presumptions of the business judgment rule. Nor in a demand-excused derivative case should it support a finding that a majority of the board could not impartially consider a pre-suit demand because they face a substantial likelihood of liability.

The company can and should state in its proxy statement that if there is a significant shareholder vote against the executive compensation disclosed in the proxy, the board will evaluate whether any actions are appropriate in response. Prospectively, companies should evaluate their compensation standards with the benefit of independent legal and compensation consultant advice, studying the 2011 proxy season's negative shareholder votes for patterns. Companies should not overlook that reports from independent proxy advisory services frequently play a key role in say-on-pay votes, and should consider communicating with their largest shareholders about compensation standards in an effort to preempt the negative publicity and potential shareholder litigation that an adverse say-on-pay vote may occasion.

Prior to approving executive compensation, advisers to the board and its compensation committee also should ensure that compensation determinations are supported by relevant empirical data and comparable company information. Minutes should reflect due consideration and deliberation on executive compensation. Proxy statement CD&A disclosures, especially about how executive performance is measured, should be clear and complete. These measures will maximize the likelihood of say-on-pay approval, and best position the board in the event of an adverse shareholder vote.

Endnotes:

1. SEC Office of Investor Education and Advocacy, "Say on Pay and Golden Parachute Votes" (March 2011) available at http://www.sec.gov/investor/alerts/sayonpay.pdf.

2. Civ. Action No. 2011-cv-197841, Slip Op. (Sup. Ct. Fulton Co. Ga. Sept. 16, 2011).

3. 2011 WL 4383368 (S.D. Ohio Sept. 20, 2011).