Say-on-Pay Lawsuits – Is This Time Different?

Posted by Keith L. Johnson, Reinhart Boerner Van Deuren s.c., on Sunday February 5, 2012

In the aftermath of the first proxy season of shareholder “say-on-pay” votes under the Dodd-Frank Act, shareholders have filed derivative suits against the boards of several of the companies failing to win majority approval. Many observers have been quick to dismiss the plaintiffs’ likelihood of success in these cases, given the well-established principle that decisions on compensation lie within the board’s business judgment. However, while a Georgia court, in the Beazer Homes USA litigation, relied on the business judgment rule to dismiss a say-on-pay shareholder derivative case, at roughly the same time a federal judge in Ohio reached the opposite conclusion, refusing to dismiss a say-on-pay suit involving Cincinnati Bell. In light of these unfolding and conflicting developments, how should directors and compensation committees assess and respond to the risk of suit?

In our view, boards would be ill advised to take too much comfort in the belief that the business judgment rule will always be held to immunize compensation decisions from shareholder attack in the face of a substantial negative say-on-pay vote. The time might be coming for courts to start applying a stricter standard of review in these cases. Analysis of the rationale underlying the courts’ traditional deference to boards on compensation matters reveals that the unique circumstances presented by say-on-pay may lead to a different outcome.

For starters, consider the requirement of a pre-suit demand on the board. Prior to the 1970s, this was seen as merely a procedural step, not a bar to the courthouse door. Unlike the typical derivative action, say-on-pay lawsuits uniquely present the court with direct evidence on the policy consideration fundamental to deciding whether the suit should be allowed to proceed – that is, the extent to which other shareholders have already expressed similar concerns through their

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proxy votes. Faced with that reality, will courts be content to rely on purely procedural grounds to foreclose the shareholder-plaintiff from access to discovery and the opportunity to at least argue the merits?

Of course, overcoming the demand requirement is one thing, prevailing on the merits presents a more formidable challenge. Yet here as well, the distinctive characteristics of say-on-pay litigation call into question whether the obstacles to plaintiff recovery should retain their traditional force.

We do not presume to predict the path that courts will ultimately take – or to advocate for any particular formulation of the appropriate test. Our point is simply that the times are much riper for a reconsideration of the courts’ approach to executive compensation than most observers seem to assume. Regulatory changes have made relevant board decision factors more transparent; public anger over disproportionately spiraling executive compensation during an extended recession is putting pressure on the courts; and existing case law provides support for use of an intermediate standard of judicial review for say on pay derivative lawsuits. In other areas, mergers and acquisitions being the most notable, courts have already been increasingly willing to review the board’s decision process, without having to second guess a rational and reasonably diligent board determination.\(^3\)

Any such departure from unmitigated protections of the business judgment rule is likely to provoke three lines of objection: concerns over the resulting volume of litigation, inconsistency with existing case law, and the limiting language of the Dodd-Frank Act. However, we are not persuaded that, in the present context, any of these forecloses a more demanding standard of judicial review.

Confining judicial review to instances of a negative shareholder vote necessarily addresses the floodgates problem. Even in the absence of a new intermediate standard, investor backlash against spiraling executive compensation and growing economic inequality might spark courts to take a more aggressive approach to excessive compensation awards under the existing business judgment rule and corporate waste doctrines.\(^4\) While Section 951 of the Dodd-Frank Act makes it clear that a say-on-pay vote does not change the board’s fiduciary duties, nothing in the Act appears to preclude courts from adopting a stricter standard of judicial review.

\(^3\) Leading examples include responses to takeover bids, see Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-57 (Del. 1985), and special litigation committees, see Zapata Corp. v. Maldonado, 430 A.2d 779, 787-89 (Del. 1981).

\(^4\) For example, see In re Citigroup Inc. Shareholder Derivative Litigation, 964 A.2d 106 (Del. Ch. 2009).
How Should Boards and Compensation Committees Respond?

If our assessment is correct, those responsible for executive compensation decisions need to prepare for a period of substantial uncertainty until the issues raised by the say-on-pay suits are definitively resolved. Because that definitive resolution will ultimately come from the Delaware courts, and plaintiffs have thus far chosen to file elsewhere, answers may be a while in coming. Further, given the continuing damage to company reputations and investor relations as their pay practices are the focus of judicial and public scrutiny, companies – at least those that fail to have the suit dismissed at the demand stage – will be under strong pressure to settle rather than to pursue the case to the merits. Thus, for the foreseeable future, we would not be surprised by a variety of alternative and often conflicting outcomes, as the early examples of Cincinnati Bell and Beazer Homes suggest.

Consequently, companies should continue to consider litigation risk among the many costs of failing to win substantial shareholder support for their executive compensation arrangements. In deciding how best to prepare for this scenario, each company’s situation is different. Nevertheless, we believe that three strategies in particular should receive serious consideration by every company.

First, the company should make every effort to assure that its proxy statement describes the fundamental principles that underlie executive compensation practices. The proxy statement should also explain the performance basis for compensation awards and their alignment with larger corporate goals and policies, in as candid and complete a manner as possible.

Second, companies, particularly those whose pay practices have been questioned or criticized by investors in the past, need to significantly ratchet up the their level of engagement. In our experience, institutional investors tend to view say on pay through a wider lens – one that embodies their broader philosophy of the role that effective boards (and in particular effective independent directors) can and should play. Specifically, these investors view CEO succession and compensation as key areas in which independent board members can, on an ongoing basis, realistically affect the company’s long-term value. When investors perceive a significant disconnect between the pay and performance, they wonder whether it portends broader weaknesses in governance and oversight.

Finally, the most direct way for derivative suit plaintiffs to bypass the demand requirement under existing case law, is to create a reasonable doubt about the board’s independence. If, as we have discussed, courts do become increasingly open to suits challenging executive compensation, the independence of those involved in the compensation process will be a focal point of scrutiny.
Board member conflicts of interest, personal relationships, self-dealing and related party transactions can provide the grounds for establishing bias or lack of independence. Consequently, boards should undertake a fresh review of whether circumstances exist that impinge, or might appear to impinge, the capacity of each participant in that process to exercise independent judgment.

Conclusion

Courts are likely to face growing pressure to strengthen their oversight of board compensation decisions, particularly where a shareholder vote reveals a significant perceived disconnect between pay and performance. In order to reduce litigation risk, boards might want to improve their disclosures around executive compensation, engage with and respond to legitimate shareholder concerns and attend to removing both conflicts of interest and behavioral biases from the board’s compensation oversight practices.

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