ALERTS AND UPDATES

Georgia Court: Adverse Shareholder Say-on-Pay Vote, Without More, Does Not Invalidate or Require Rescission of Compensation Decisions Made by Directors of Delaware Corporations

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"Hindsight second-guessing and Monday morning quarterbacking of the sort Plaintiffs urge are fundamentally inconsistent with the business judgment analysis." So stated a Georgia state court,[1] which concluded that an adverse Dodd-Frank Say-on-Pay Vote was, without more, insufficient to rebut the business judgment rule's presumption as to directors' making business decisions regarding executive pay.[2]

Under the Dodd-Frank Act and associated SEC rules, a Say-on-Pay Vote[3] is advisory, non-binding, does not require rescission of a compensation plan that receives an adverse vote by the shareholders and will not create or change the fiduciary duties of the company or its board of directors.[4]

In the December 2010 proxy statement of Beazer Homes USA, Inc., a Delaware corporation headquartered in Atlanta ("Beazer"), the directors (the "Directors") recommended that the Beazer shareholders approve the 2010 executive compensation (the "2010 Compensation")[5] in a Say-on-Pay Vote. At the subsequent annual stockholders meeting in February 2011, however, a majority of voting Beazer shares was voted against the 2010 Compensation,[6] which included pay raises for Beazer executives for a year in which Beazer suffered a $34 million net loss and a 17-percent decline in share price.

After the adverse vote, plaintiffs consisting of Long Island Teamsters pension funds brought a stockholders' derivative suit in Georgia state court[7] against the Directors and executive officers, asserting that (i) in approving the 2010 Compensation, recommending that the shareholders approve the 2010 Compensation by a Say-on-Pay Vote and failing to rescind the 2010 Compensation after the adverse vote, the Directors breached their fiduciary duties to Beazer; and (ii) Beazer executives were unjustly enriched by the 2010 Compensation.[8]

The *Beazer* court concluded that the plaintiffs failed to rebut the business judgment presumption.[9] The court determined that, as a simple matter of sequencing, the Directors could not have considered the results of the February 2011 Say-on-Pay Vote when the Directors, acting at the outset of 2010, approved and recommended the 2010 Compensation, including the metrics for performance compensation. The mere existence of the Say-on-Pay Vote, therefore, cast no doubt that the Directors acted on an informed basis, in good faith and in Beazer's best interests a year earlier. The court also concluded that the Dodd-Frank Act expressly preserved, without adding to, the preexisting fiduciary framework regarding the executive compensation decisions made by boards of directors.[10] Therefore, the court looked to the preexisting Delaware fiduciary duty framework.

Under Delaware law, directors have "wide discretion" to set executive compensation, and "where, as here, a payment decision made by a majority of disinterested directors, it is entitled to the protection of the business judgment rule."[11] The court concluded that neither the existence of the adverse Say-on-Pay Vote nor the decision of the Directors not to rescind the 2010 Compensation rebutted the business judgment protection afforded the Directors under Delaware law.[12]

The court also concluded that the plaintiffs failed to state a claim for unjust enrichment against Beazer executives. The plaintiffs' only allegation in support of their claim for unjust enrichment was that the 2010 Compensation was "excessive" in light of Beazer's net loss that year. The plaintiffs did not allege that the compensation awarded to Beazer executives was inconsistent with the executives' achievement of performance targets established by Beazer's compensation committee. In dismissing the unjust enrichment claim, the court drew upon Delaware precedent[13] that held, as a matter of law, that executives who receive compensation for providing services to a company pursuant to a contractual agreement approved by the board are not unjustly enriched.[14]

Conclusion and Thoughts for the Future

Overriding a board's decision on executive compensation by alleging a breach of fiduciary duties is a high hurdle to clear for shareholders bringing derivative suits. The business judgment rule continues to offer a strong presumption that directors making business decisions act in the best interests of the company.

In viewing the decision of a Georgia court that interpreted Delaware law, the key lessons appear to be (1) a negative Say-on-Pay Vote does not suggest that there is a per se violation of fiduciary duties; and (2) fiduciary duties do not require boards to revisit prior compensation decisions based on a negative Say-on-Pay Vote.

Still, the *Beazer* opinion implies at least two ways that a stockholders' derivative suit alleging breach of director fiduciary duties regarding executive compensation might survive a motion to dismiss:

- A plaintiff might allege that a given challenged compensation was not in fact awarded consistent with executives' performance against predetermined financial and non-financial goals or that the board did not believe such goals were critical to enhancing stockholder value.
- A plaintiff might allege that a board of directors omitted material, particularized facts from a recommendation that a company's shareholders approve executive compensation in a Say-on-Pay Vote.

In response to the *Beazer* decision, the facts the court cited as central to its conclusion and the above implications, boards of directors in general and compensation committees in particular might be well advised to:

- Revisit and bolster the ways in which they set executive performance goals, measure performance against those goals and document associated compensation decisions.
- Ensure accurate and complete disclosures to shareholders regarding executive compensation prior to any recommendation for a Say-on-Pay Vote.

The views expressed in *Beazer* shed first light on Say-on-Pay-related breach of fiduciary duty claims against boards of directors of Delaware corporations. In considering the views of the *Beazer* court, we must be mindful that the case reflects the views of a Georgia court interpreting Delaware law; a Delaware court might very well consider the matter differently. We anticipate additional illumination as other cases progress through the courts in which they are filed.

For Further Information

If you have any questions regarding the *Beazer* case, the Dodd-Frank Act's Say-on-Pay provisions or how either may affect your company, please contact Blake Allen, Joel Ephross, David Kaufman, Laurence Lese, Darrick Mix, Richard Silfen or Dustin Hawks; one of the members of the Securities Law Practice Group; or the lawyer in the firm with whom you are regularly in contact.

Notes

1. *Teamsters Local 237 Additional Security Benefit Fund v. McCarthy*, No. 2011-cv-197841 at 11 (Ga. Super. Ct Sept. 16, 2011) (order granting motion to dismiss) ("*Beazer*").
2. The business judgment rule presumes that the directors of Delaware corporations act on an informed basis, in good faith, and with the honest belief that their business decisions are in the best interests of the corporation.
3. Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), signed into law on July 21, 2010, created Section 14A of

the Securities Exchange Act of 1934. The Dodd-Frank Act and the associated rules adopted by the U.S. Securities and Exchange Commission (SEC) require a periodic shareholder vote on the compensation of a company's named executive officers – a so-called "Say-on-Pay Vote." The SEC's rules apply to issuers that have a class of equity securities registered under Section 12 of the Exchange Act and are subject to the SEC's proxy rules.

4. The Dodd-Frank Act provides that Say-on-Pay Votes "shall not be binding on the issuer or the board of directors of an issuer, and may not be construed (1) as overruling a decision by such issuer or board of directors; (2) to create or imply any change to the fiduciary duties of such issuer or board of directors; [or] (3) to create or imply any additional fiduciary duties for such issuer or board of directors." Dodd-Frank Act, 124 Stat. 1376, 1900.

5. The 2010 Compensation in question in the lawsuit was paid based on the executives' achievement of specific incentive performance goals that Beazer's compensation committee had established at the outset of Beazer's 2010 fiscal year and on the guidelines set forth in Beazer's equity incentive plan, the terms of which had been disclosed to Beazer stockholders in February 2010 and approved by them in April 2010.

6. Approximately 54 percent of the shares that voted on the proposal voted against the compensation paid to the named executive officers for fiscal year 2010.

7. Because Beazer was incorporated in Delaware, the Georgia court had to "apply Delaware law in adjudicating matters that implicate Beazer's internal corporate affairs." *Beazer*, No. 2011-cv-197841 at 4. Such matters included whether plaintiffs had standing to bring a stockholders' derivative suit, whether plaintiffs properly alleged legal excuse for failure to make a pre-suit demand and whether plaintiffs stated a claim upon which relief may be granted. The court's analysis of Delaware's business judgment presumption impacted the latter two matters.

8. The *Beazer* plaintiffs also asserted two additional causes of action, for breach of contract and aiding and abetting breaches of fiduciary duties, against both

PricewaterhouseCoopers LLP and MarksonHRC, LLC, which were alleged to have provided executive compensation consulting or advisory services relating to the 2010 Compensation. The *Beazer* court dismissed the plaintiffs' complaint in its entirety.

9. Plaintiffs also failed to allege excused demand. In order to bring a derivative suit on behalf of a Delaware corporation, prospective plaintiffs must either make a pre-suit demand that the board evaluate whether to bring the claims or plead particularized facts demonstrating legal excuse from the demand requirement. Under the test set forth in *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); Del. Ch. Ct. R. 23.1(a), where the suit challenges a board decision, those particularized facts must (i) raise a reasonable doubt that a majority of the board was "disinterested" and "independent"; (ii) raise a reasonable doubt that the challenged board decision was a valid exercise of business judgment; or (iii) show that a majority of the board faces a "substantial likelihood" of personal liability. Because only one of the seven Beazer Directors was alleged to have received the 2010 Compensation, the *Beazer* plaintiffs did not even attempt to challenge the Directors' disinterestedness and independence under the first prong of the *Aronson* test; rather, the plaintiffs sought to attack the validity of the Directors' exercise of business judgment under the second prong.

10. See Note 4 above.

11. *Beazer*, No. 2011-cv-197841 at 11–12 (quoting *Brehm v. Eisner*, 746 A.2d 244, 262 n.56 (Del. 2000) and *Orban v. Field*, No. Civ. A. 12820, 1997 WL 153831, at *10 (Del. Ch. Apr. 1, 1997)).

12. For the same reasons, plaintiffs could not show that a majority of the Directors faced a substantial likelihood of personal liability.

13. *Beazer*, No. 2011-cv-197841 at 23 (quoting *Highland Legacy Ltd. v. Singer*, No. Civ. A. 1566-N, 2006 WL 741939, at *7 (Del. Ch. March 17, 2006)).

14. A different result was recently reached the United States District Court for the Southern District of Ohio in the *Cincinnati Bell* case. *NECA-IBEW Pension Fund v. Cox*, No. 1:11-cv-451 (S.D. Ohio Sept. 20, 2011) (order denying motion to dismiss) ("*Cincinnati Bell*"). Although several of the facts of *Cincinnati Bell* are similar to those of *Beazer*, a few notable differences may account for the difference in result:

    (1) in *Cincinnati Bell*, plaintiffs alleged that the challenged compensation was awarded in violation of the company's executive compensation program, particularly the pay-for-performance policy, whereas the challenged compensation in *Beazer* was awarded consistently with an established compensation program;

    (2) In *Cincinnati Bell*, under Ohio law demand was presumptively futile where the directors were adversely interested or involved in the transactions attacked, whereas in *Beazer*, to properly plead excused demand under Delaware law, plaintiffs had to raise a reasonable doubt that the challenged board decision were a valid exercise of business judgment or show that the Directors faced a substantial likelihood of personal liability; and

    (3) In *Cincinnati Bell*, the court claimed that under Ohio and Federal law, "the business judgment rule imposed a burden of proof, not a burden of pleading" and that "[w]hile a plaintiff must plead an exception to the business judgment rule, he is not required to plead the exception with particularly . . . ." ; in *Beazer*, however, under Delaware law plaintiffs were required to plead particularized facts that raised a reasonable doubt that the board decision was a valid exercise of business judgment in order to properly allege demand futility.

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