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Federal Court Rejects Shareholder "Say-on-Pay" Suit

The U.S. District Court for the Northern District of California on March 7, 2012 dismissed a derivative suit brought by shareholders of Intersil Corporation for breach of fiduciary duty premised on shareholders' disapproval of the company's executive compensation plan in a non-binding "say-on-pay" vote mandated under the Dodd-Frank Act.[1] In dismissing the case, however, the court pointedly sought to determine what weight should be accorded negative "say-on-pay" votes.

Among the numerous requirements included in the Dodd-Frank Act, which was enacted in July 2010, was a requirement for all public companies to conduct a non-binding shareholder vote on executive compensation at least once every three years.[2] Nearly 2,200 issuers held "say-on-pay" votes in 2011. Notwithstanding the non-binding nature of "say-on-pay" votes and the express intent of Congress to avoid challenging a board of directors' fiduciary duties, shareholders have launched lawsuits against a growing number of companies, and their senior executive officers, directors, and outside compensation consultants, as a result of negative "say-on-pay" votes.[3]

1 *Laborers' Local #231 Pension Fund v. Bell, et al.*, No. 5:11-cv-4093-EJD (N.D. Cal.).

2 15 U.S.C. § 78n-1.

3 In addition to Intersil, the companies sued include KeyCorp, Occidental Petroleum Corporation, Jacobs Engineering Group Inc., Beazer Homes USA, Inc., Umpqua Holdings Corporation, Hercules Offshore, Inc., Cincinnati Bell, Monolithic Power Systems, Inc., Navigant Consulting, Inc., and Johnson & Johnson.

The facts alleged by shareholders in the Intersil case are similar to those in other "say-on-pay" cases: (i) the corporation adopted a "pay-for-performance" philosophy; (ii) the corporation experienced a decrease in certain financial measures (net income and earnings per share); (iii) the board of directors and its compensation consultant both recommended an increase in executive compensation despite the decrease in those financial measures; and (iv) the shareholders delivered a negative vote on "say-on-pay" (56% of voting shareholders voted "no"). Plaintiff asserted that the negative "say-on-pay" vote demonstrated that the compensation plan approved by Intersil's board was not in the shareholders' best interest and was sufficient to rebut the presumptions of the business judgment rule and excused demand.[4]

Judge Edward Davila of the federal district court in San Jose disagreed and, in a lengthy decision, granted the defendants' motion to dismiss with leave to amend. The court held that the complaint did not adequately allege that demand was futile under the two-pronged test articulated in *Aronson v. Lewis,*[5] because it failed to allege that the directors were "interested" or that there was a reasonable doubt that the approval of the compensation was entitled to the protection of the business judgment rule.

4 Intersil is a Delaware corporation, so Delaware law applied.

5 473 A.2d 805 (Del. 1984).

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With respect to lack of director independence, the court held that the complaint contained no allegation that a majority of the board was "interested" in approving the compensation plan and that the mere threat of personal liability alone was "insufficient to challenge either the independence or disinterestedness of directors" under Delaware law.[6]

More importantly, the court rejected plaintiff's theory that the negative "say-on-pay" vote mandated under Dodd-Frank alone rebutted the business judgment rule. In reaching this holding, however, the court devoted significant analysis to determining what weight courts should give to negative "say-on-pay" votes in shareholder suits. The court observed that, although "Congress was explicit that the shareholder vote on executive pay is non-binding," the "[Dodd-Frank] Act is silent on what considerations courts should give to the shareholder vote."[7] After reviewing the legislative history of the Dodd-Frank Act, the court concluded "Congress must have intended for the shareholder vote to have some weight if . . . the goals of [the Act's "say-on-pay" provision] are to empower shareholders and to hold executives accountable."[8] Accordingly, the court held that "a shareholder vote on executive compensation under the [Dodd-Frank] Act has substantial evidentiary weight and *may* be used as evidence by a court in determining whether the second prong of the *Aronson* test has been met."[9] Importantly, the court went on to rule, however, "that the shareholder vote *alone* is not enough to rebut the presumption of the business judgment rule."[10]

Prior decisions in other "say-on-pay" cases had presented mixed results. A federal court in Ohio had previously denied a similar motion to dismiss in a case involving Cincinnati Bell, although its decision was based on Ohio law.[11] On the other hand, in cases involving Beazer Homes USA and Umpqua, a Georgia state court in Atlanta and federal magistrate judge in Oregon, respectively, opined that the complaints there also did not meet the test for establishing demand futility set forth in *Aronson*.[12] None of these cases, however, opined on the weight to be accorded to shareholder votes.

This decision represents a clear victory for companies and their directors and officers facing shareholder litigation in the wake of negative "say-on-pay" votes, and firmly establishes a national trend rejecting such suits. That said, the court's holding that negative shareholder votes are entitled to "substantial weight" in determining if the business judgment rule is rebutted provides plaintiffs some succor, especially in cases where plaintiffs can allege additional facts to raise a reasonable doubt about a board's ability to independently evaluate a litigation demand.

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6 Opinion at 7.

7 *Id.* at 11.

8 *Id.* at 12.

9 *Id.* (emphasis in original).

10 *Id.* (emphasis in original).

11 *NECA-IBEW Pension Fund v. Cox*, No. 1:11-cv-451, 2011 U.S. Dist. LEXIS 106161 (S.D. Ohio Sept. 20, 2011). That court has subsequently called into question whether it had subject matter jurisdiction to enter that order; the case recently settled while the parties were briefing the issue.

12 *Teamsters Local 237 v. McCarthy*, 2011 CV 197841 (Ga. Super. Ct., Fulton Cty.) ("*Beazer Homes*"); *Plumbers Local No. 137 Pension Fund v. Davis, et al.*, No. 3:11-cv-633-AC (D. Ore.) ("*Umpqua*"). The decision in *Beazer Homes* is unreported. In Umpqua, the magistrate judge's decision was a recommendation that was adopted by the federal judge. The decision was based on Oregon law, which has substantially adopted Delaware's corporations law.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or the attorney listed.

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