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Defending Against Shareholder "Say-On-Pay" Suits

Nearly 2,200 issuers held "say-on-pay" votes in 2011.[1] Shareholders have overwhelmingly voted in favor of the proposed compensation plans, rejecting management compensation proposals in only about 40 instances. The companies that lost the vote, however, have been frequent targets of shareholder derivative litigation. These actions have not yet resulted in substantive decisions and, until they do, more cases can be expected to be filed. The risk and likely spread of litigation following a non-binding shareholder vote disapproving executive compensation thus raises the stakes on say-on-pay votes in an unexpected way.

The Dodd-Frank Act provides that "say-on-pay" votes are non-binding and may not be construed as overruling a decision by, or modifying the fiduciary duties of, a board of directors.[2] 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 at least seven companies, and their senior executive officers, directors and outside compensation consultants, as a result of negative "say-on-pay" votes.[3] The shareholder derivative litigation complaints in these actions almost uniformly allege breach of duty

1 On January 25, 2011, the Securities and Exchange Commission (the "SEC") adopted final rules requiring "say-on-pay" votes on executive compensation (including "frequency" of "say-on-pay" votes) and "golden parachute" arrangements in connection with change-in-control transactions. These rules are required by Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). The final rules became effective on April 4, 2011. The adopting release can be found at http://www.sec.gov/rules/final/2011/33-9178fr.pdf.

2 Rule 14a-21(a) of the Securities Exchange Act of 1934, as amended, provides that registrants are required to include in their proxy statements a "shareholder advisory vote to approve the compensation of their named executive officers." Rule 14a-21(b) requires that registrants submit to their shareholders a separate advisory vote on whether the "say-on-pay" vote "should occur every 1, 2 or 3 years." Rule 14a-21(c) mandates a shareholder advisory vote on "golden parachute" arrangements in connection with change-in-control transactions. The requirements for "say-on-pay" votes on executive compensation (including "frequency" of "say-on-pay" votes), but not "golden parachute" arrangements, have been deferred for two years for smaller reporting companies.

3 The companies sued include KeyCorp, Occidental Petroleum Corporation, Jacobs Engineering Group Inc., Beazer Homes USA, Inc., Umpqua Holdings Corporation, Hercules Offshore, Inc., and Cincinnati Bell. The KeyCorp and Occidental cases have settled (the former for payment of $5,000 to named plaintiffs and $1.75 million in attorneys' fees, plus agreed-upon reforms to corporate governance procedures); the remainder of the cases are pending. *See, e.g.*, *King v. Meyer*, 10-cv-01786 (N.D. Ohio) (KeyCorp); *Gusinsky v. Irani*, BC442658 (Cal. Super. Ct., Los Angeles Cty.) (Occidental); *Witmer v. Martin*, BC454543 (Cal. Super. Ct., Los Angeles Cty.) (Jacobs Engineering); *Teamsters Local 237 v. McCarthy*, 2011 CV 197841 (Ga. Super. Ct., Fulton Cty.) (Beazer Homes); *Plumbers Local No. 237 v. Davis*, 11-cv-633 (D. Ore.) (Umpqua Holdings); *Matthews v. Rynd*, 2011 34508 (Tex. Dist. Ct., Harris Cty.) (Hercules); *NECA-IBEW Pension Fund v. Cox*, 11-cv-451 (S.D. Ohio) (Cincinnati Bell).

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by the company's directors and officers, aiding and abetting that breach and breach of contract by the compensation consultants, unjust enrichment of the officers and, in some cases, corporate waste or breach of contract by the directors. With respect to the breach of fiduciary duty, Plaintiffs' theories focus on the duty of loyalty, in some cases mentioning related duties of candor, good faith and/or independence. The fiduciary duty of care has received less emphasis in the complaints filed to date. By focusing on loyalty-based duties instead of the duty of care, Plaintiffs have sought to avoid exculpatory provisions and defenses available for the latter type of breach (such as Section 102(b)(7) of the Delaware General Corporation Law).

The facts alleged in the complaints follow a common pattern: (i) a corporation adopts a "pay-for-performance" philosophy or guidelines; (ii) the corporation experiences a decrease in financial performance; (iii) the board of directors and the compensation consultant both recommend an increase in executive compensation despite the decrease in financial performance; (iv) the shareholders deliver a negative vote on "say-on-pay"; and (v) the board of directors nonetheless approves or fails to rescind, alter or amend its recommendation for increased executive compensation. Plaintiff shareholders support their allegations in some cases by referring to tangential facts, such as receipt of TARP funds; compensation paid by peer companies; and critical press commentary about a company or its executives. In the Cincinnati Bell case, plaintiffs also sought a preliminary injunction to freeze executive pay, but the court declined to issue a ruling on an expedited basis.

While not emphasized in the complaints, proxy advisory firm Institutional Shareholder Services ("ISS") criticized nearly all of the companies that lost their shareholder votes for a disconnect between pay and performance and recommended against approval of their proposed compensation packages. The ISS also recommended "no" votes for roughly 150 other companies where shareholders nonetheless elected to approve executive compensation.

The cases filed thus far challenge the business judgment exercised by the board of directors based on an "independent business judgment" theory. Plaintiff shareholders argue that the negative votes on "say-on-pay" reflect the "independent business judgment" of the shareholders that executive compensation packages are unreasonable, disloyal, excessively large, irrational and not in the best interests of the corporation. This theory seeks to functionally supplant a board's business judgment by taking the position that the shareholders were equally capable of assessing, and did assess, the merits of the proposed executive compensation package based on the same information that the directors had at their disposal. Accordingly, the contrary position taken by the board of directors rebuts the presumption that the board is entitled to the protection of the business judgment rule. On a related note, each of the derivative lawsuits filed to date claims that it would be futile to make a pre-suit demand on the board of directors due to the boards' past recommendation and subsequent failure to take action disapproving increased executive compensation. Whether courts will accept this argument against the independence of the board remains to be seen.

Although the complaints do not purport to assert claims for federal securities violations, the factual allegations characterize the proxy statement recommendations by boards of directors to approve executive and board compensation packages under these circumstances as false, misleading and part of an overall scheme to enrich themselves at the expense of the corporation. The complaints allege that the boards of directors knew the executive compensation packages were inappropriate and that they should have disclosed this to the shareholders in the corporation's proxy statement, or that statements about a corporation's pay-for-performance philosophy are rendered false and misleading by failure to adopt shareholders' negative say-on-pay vote.

The utilization of outside compensation consultants did not deter the filing of derivative actions. Rather, plaintiff shareholders have accused compensation consultants of breach of contract for failure to render sound and competent advice and services regarding executive compensation packages and aiding and abetting the breach of fiduciary duty by offering recommendations, which are allegedly unreasonable and made in bad faith, to increase executive compensation despite declines in key financial performance indicators.

One of the sued companies, Umpqua Holdings Corp., has embarked on a robust, multi-prong defense that may—if it succeeds—provide a playbook for other companies subject to say-on-pay litigation. On the public relations front, Umpqua has generated favorable press coverage about its performance and vowed to vigorously defend against a lawsuit brought by attorneys who "create fees by dragging the names of reputable companies through the mud."[4] On June 20, within a

[4] *Portland Business* Journal, May 27, 2011. The article also noted that "the 'no' vote on Umpqua's pay proposal left many scratching their heads. [CEO] Davis guided Umpqua

month of being sued, Umpqua filed an 8-K announcing that it would "more closely link" executive compensation to performance, in express acknowledgment of the say-on-pay vote, by adding performance-related conditions to the vesting of stock awards and options.[5] One week later, Umpqua filed its motion to dismiss, leading with the argument that the derivative lawsuit must be dismissed for shareholders' failure to make a pre-suit demand. Umpqua also argues that the express language of the Dodd-Frank Act does not alter or add to a board's traditional fiduciary duties so as to create a new basis for liability or rebut a board's business judgment, so plaintiffs' fiduciary duty claims cannot proceed. Plaintiffs' opposition, filed at the end of July, argues that the board's alleged breach of fiduciary duty in approving the pay increases makes any demand futile and strips the Umpqua board of any business judgment protection. The district court's ruling on this motion, or rulings by any of the other courts where these say-on-pay cases have been filed,[6] will be illuminating for pending and future say-on-pay cases.

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For more information on "say-on-pay" rules, including how to prepare for and/or respond to a negative "say-on-pay" vote, please contact the Dechert attorney with whom you regularly work.

through the financial crisis relatively unscathed and is credited with making the bank one of the state's most admired and gilded brands."

5 Umpqua Holdings Corp. Form 8-K (filed June 20, 2011).

6 For instance, in the case against Cincinnati Bell, Defendants' motion to dismiss and Plaintiffs' motion for preliminary injunction have been briefed.

New Things to Think About

- *Continue and improve advance communications efforts.* Communication outreach efforts to large shareholders and the proxy advisory firms in advance of the annual proxy season continues to be wise, and should now include discussion of the executive compensation packages and "say-on-pay" votes. It is also important to adequately describe qualitative and quantitative reasons in support of executive compensation packages in the proxy statement. If a company receives a negative recommendation from a proxy advisory firm, it may be possible to reverse the recommendation, particularly if the metrics used by the firm are not appropriate. Pfizer and JPMorgan Chase succeeded in reversing negative recommendations this year.
- *Prepare for defensive communications.* If a negative "say-on-pay" recommendation cannot be avoided or reversed, early consideration should be given to what should be said when to the shareholders. The results of the shareholder vote must be disclosed almost immediately after the meeting. If the company decides to include a reasoned analysis in its Form 8-K disclosing the results of the vote explaining why the executive compensation package remains appropriate, that analysis will need to be prepared in advance.
- *Consider post-vote measures to address shareholder concerns*. Umpqua's decision to link the vesting of stock awards and options to performance is one example of a *post-hoc* measure to take the sentiments expressed by a negative shareholder vote into account. Particularly if say-on-pay litigation proliferates, following a disapproving say-on-pay vote companies may wish to consider having some or all of the independent directors examine executive pay issues.

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