October 9, 2012

Say-on-Pay Cases – Update

In 2011, most public companies were, for the first time, required by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") to submit to shareholders a nonbinding advisory vote on executive compensation. The vast majority of public companies received support from more than a majority of votes cast. However, approximately 45 companies did not. As feared, lawsuits alleging violation of fiduciary duties were filed against directors of some companies that did not receive majority support, despite explicit language in Dodd-Frank that the advisory vote would not change the standards of conduct for directors. Below is a summary of the lawsuits of which we are aware and in which a written opinion has been filed. In all but one of these cases, motions to dismiss were granted, with the courts holding that failed say-on-pay votes cannot establish demand futility. Additionally, we have included the case against the Board of Directors of Citigroup, although as of this writing, there has not been a motion to dismiss filed.

1. *Teamsters Local 237 Additional Security Benefit Fund v. McCarthy*, No. 11-197841 (Ga. Super. Ct. Sept. 15, 2011) ("Beazer Homes").

Shareholders of Beazer Homes USA, Inc. filed a derivative suit claiming breach of fiduciary duty. The court, citing the well-known *Aronson* case[1], reviewed the two situations in which demand may be excused as futile under Delaware law: first, when a majority of the board is either interested or not independent and, second, when a reasonable doubt is created about whether the decision was a valid exercise of business judgment.

The court correctly noted that directors are not interested merely because they approved the transaction in question. The court then declared that a shareholder advisory vote that occurred after the compensation decisions were made by the board could not rebut the business judgment presumption. The court stated that a plaintiff trying to rebut the business judgment presumption must show that the board "failed to act on an informed basis, in good faith, and in the honest belief that the decisions were in Beazer's best interest." The court noted that Delaware law does not support the notion that the "independent business judgment" of the corporation's shareholders, in the form of a negative say-on-pay vote after compensation decisions have already been made, could override the protections of the business judgment rule. Thus, the court dismissed the plaintiff's complaint for failure to make demand.

2. *NECA-IBEW Pension Fund v. Cox*, No. 11-451 (S.D. Ohio Sept. 20, 2011).

In this case, which has been roundly criticized, a shareholder suit against the directors of Cincinnati Bell Inc. survived a motion to dismiss. The court agreed with the plaintiff that

[1] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

demand would be futile because the directors approved the compensation in question. This holding ignores the general rule that the fact that directors may be asked to sue themselves for approving a challenged decision is not enough to make them interested and thereby excuse demand. The court then stated that a plaintiff is not required to plead particularized facts that would rebut the business judgment rule. Instead, the court stated that defendants could use the business judgment rule as an affirmative defense at trial, but that the lack of particularized facts in the complaint was not enough to grant defendants' motion to dismiss. The court concluded that the negative say-on-pay vote created "a reasonable doubt that the challenged transaction is the result of a valid business judgment." This finding was incorrect because shareholder disapproval of a corporate action cannot have any bearing on whether the board's process entitled the decision to the protection of the business judgment rule. This opinion has been heavily criticized; indeed, the Umpqua Holdings opinion (see below) questioned whether it would ever be considered good law. The court may have been influenced by "the company's declining financial performance."

3. *Dennis v. Hart*, No. 11cv2271 WQH (S.D. Cal Jan. 6, 2012).

Shareholders brought a derivative suit in state court against PICO Holdings, Inc., after that company failed to receive majority support for its 2011 say-on-pay vote. Defendants removed to federal court based on plaintiff's claim that the Dodd-Frank Act, a federal act, changed state law fiduciary duties. The federal court dismissed this claim, quoting from the statute that "[t]he language of the statute expressly states that it 'may *not* be construed ... to *create* or *imply* any *change* to fiduciary duties' nor does it '*create or imply* any additional fiduciary duties.'" (emphasis in original). The court remanded the state law claims back to state court.

4. *Plumbers Local No. 137 Pension Fund v. Davis*, No. 03:11-633-AC (D. Or. Jan. 11, 2012) ("Umpqua Holdings").

Several executive officers of Umpqua Holdings Corp. received pay increases in 2010 because the corporation's performance met predetermined performance thresholds. However, total shareholder return declined and shareholders filed a derivative suit in the District Court for the District of Oregon. The plaintiff did not file a pre-suit demand and the defendants moved to dismiss because the plaintiff could not show that demand was futile.

The court reviewed the two situations in which demand may be excused based on futility under Oregon law (which is the same as Delaware law in this regard): first, when a majority of the board is either interested or not independent and second, when a reasonable doubt is created about whether the decision was a valid exercise of business judgment.

The court found that only one director directly benefited from the corporation's 2010 pay increases and thus the majority of the board was not interested.

Furthermore, the court found that the plaintiff did not raise a reasonable doubt that the approval of the 2010 compensation was a valid exercise of the board's business judgment. This is the crucial part of the holding because the court stated that a negative say-on-pay vote does not rebut the business judgment presumption. Compensation decisions are typically protected by the business judgment rule, and the mere fact that compensation decisions were approved during a time of negative shareholder returns, or that a subsequent advisory vote by shareholders did not receive majority support, is not enough to rebut the business judgment presumption. Importantly, the court noted that Dodd-Frank explicitly states that the advisory vote will not change the fiduciary duty of directors.

Because the plaintiff could not show that demand was excused as futile, the defendants' motion to dismiss for failure to make demand on the board was granted.

5. *Jacobs Engineering Group Inc. Consolidated Shareholder Derivative Litigation*, No. BC454543 (Super. Ct. Cal. Mar. 7, 2012).

Shareholders filed a derivative suit against Jacobs Engineering Group Inc. after that company did not receive majority support in its 2011 say-on-pay vote. The court, citing *Aronson*, stated that California law follows Delaware law for establishing demand futility, that is, the plaintiff must either show that a majority of directors are interested, or the challenged transaction was not a result of valid business judgment.

As to the first *Aronson* prong, the court found that because only one director was also an officer who received compensation under the company's executive compensation plan, a majority of officers were not interested. Also, the fact that the remaining directors might later be liable for approving the compensation did not make them interested when they approved it. Finally, the Dodd-Frank Act, which created the mandatory advisory say-on-pay vote, did not change any standards of being interested, *i.e.*, the directors did not become interested once they learned that a majority of the company's shareholders did not support the company's 2010 executive compensation.

As to the second *Aronson* prong, the court reviewed California's business judgment rule, which states that if directors were disinterested, acted in good faith and were reasonably diligent of informing themselves of the facts, then a court will not second guess the directors' decisions. The court found that the mere fact the company's shareholders later rejected the say-on-pay vote was not enough to show that the compensation decisions were not a product of valid business judgment. Accordingly, the court dismissed the suit.

6. *Laborers' Local v. Intersil Corp.*, No. 5:11-CV-04093 (N.D. Cal. Mar. 7, 2012).

This opinion followed a pattern similar to the Umpqua Holdings and Beazer Homes opinions. Intersil Corporation did not receive the support of a majority of votes cast on its 2011 say-on-pay vote. The plaintiff filed a derivative suit claiming that the directors violated their fiduciary duties by approving the company's 2010 pay package and contended that demand was futile. The court correctly noted that demand is excused for a Delaware corporation if a majority of the board is interested or not independent or if the complaint raises a reasonable doubt as to whether the transaction is a valid exercise of business judgment. Like the Umpqua Holdings and

Beazer Homes cases, the court correctly ruled that the mere threat of personal liability for approving a questioned transaction does not make a director interested or not independent. Likewise, the court correctly stated that a negative say-on-pay vote, without more, is insufficient to raise a reasonable doubt as to whether the compensation decisions by the board of directors are entitled to business judgment protection. Accordingly, the suit was dismissed.

7. *Weinberg v. Gold*, No. JKB-11-3116 (D. Md. Mar. 12, 2012).

In this case, the plaintiff sued the directors of BioMed Realty Trust, Inc., a Maryland corporation, after the company received a negative say-on-pay vote in 2011. The plaintiff alleged that the members of the board of directors, by not rescinding approval of 2010 executive compensation after the negative vote, violated their duties. The defendants moved to dismiss for failing to make pre-suit demand on the board and failing to plead demand futility.

In Maryland, the futility exception is much narrower than in many other states. To excuse demand, a complaint must "clearly demonstrate, in a very particular manner, either that (1) a demand, or a delay in awaiting a response to a demand, would cause irreparable harm to the corporation, or (2) a majority of the directors are so personally and directly conflicted or committed to the decision in dispute that they cannot reasonably be expected to respond to a demand in good faith and within the ambit of the business judgment rule."[*]

The court concluded that directors and/or committee members are not conflicted simply because they participated in the compensation decision. Additionally, the threat of liability will not cause a director to become conflicted; otherwise, every derivative suit that named directors as defendants would be excused from pre-suit demand.

Finally, the court correctly noted a key difference in demand futility between Maryland and Delaware. For derivative suits against a Maryland corporation, allegations that directors' actions were not the product of valid business judgment are irrelevant in the analysis of demand futility. In Delaware law, such allegations, if they are specific enough to raise a reasonable doubt, may satisfy the demand futility exception.

The court concluded that a majority of the company's directors were not conflicted and dismissed as irrelevant the plaintiff's allegations that the board's approval of executive compensation was not the product of valid business judgment. The defendants' motion to dismiss was granted.

8. *Moskal v. Pandit*, No. 12-CV-3114 (S.D.N.Y. filed Apr. 19, 2012).

On April 17, 2012, Citigroup Inc. held its annual meeting of shareholders. Shares representing a majority of votes cast voted against approving Citigroup's executive compensation. This was one of the most high-profile failed say-on-pay votes yet. Two days later, shareholders of Citigroup Inc. filed a derivative suit in the U.S. District Court for the

[*] *Werbowsky v. Collomb*, 766 A.2d 123, 133-34 (Md. 2001).

Southern District of New York alleging that members of the Board of Directors had violated their fiduciary duty by approving excessive compensation for 2011. The Complaint stated that the level of 2011 executive compensation amounted to a breach of duty because the Company's revenue and share price declined in 2011. The Complaint further stated that the inference that the approval of excessive compensation for 2011 amounted to a breach of fiduciary duties was supported by the fact that the Company's shareholders did not approve its executive compensation, and that the Company failed to respond to the failed say-on-pay vote. Although the Complaint was just recently filed, it appears to be very similar the cases discussed above, and the plaintiffs likely have a similarly slim chance of prevailing after the defendants file a motion to dismiss.

9. *Iron Workers Local No. 25 Pension Fund v. Bogart*, No 11-4604 PSG (N.D. Cal. June 13, 2012).

In this case, shareholders brought a derivative suit against Monolithic Power Systems, Inc., after the company's shareholders rejected its say-on-pay vote in 2011. The defendants moved to dismiss for lack of demand. The court applied the *Aronson* test to determine if demand was futile, as plaintiffs contended. For the first prong, the court found that a majority of the directors were not interested because only two of seven directors were also officers who received compensation under the approved executive compensation plan. For the second prong, the court found that the failed say-on-pay vote did not cast doubt on the good faith of the directors in approving the compensation, as the plaintiffs had argued. The defendant's motion to dismiss was granted.

10. *Gordon v. Goodyear*, No. 12 C 369 (N.D. Ill. July 13, 2012).

In this case, a shareholder brought a derivative suit against Navigant Consulting, Inc., alleging breach of fiduciary duties stemming from the shareholders of the company rejecting the company's 2011 say-on-pay proposal. Plaintiff did not make a demand on the board, and the defendants moved to dismiss. The plaintiff argued demand futility; the court applied the Aronson test, and ultimately granted the motion to dismiss. For the first prong, the court found that a majority of the directors were not interested because only one of eight directors was also an officer who received compensation under the approved executive compensation plan, and that director was not on the compensation committee that recommended the compensation package to the full board for approval. For the second prong, the court found that the failed say-on-pay vote, per the explicit text of the Dodd-Frank Act, did not change the business judgment rule under Delaware law, nor were there any other facts present to indicate that the directors' decision was not a valid exercise of business judgment.

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As always, we and our colleagues are available at any time to discuss these or other matters.

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