DO "SAY-ON-PAY" VOTES SAY ANYTHING ABOUT DIRECTOR FIDUCIARY DUTIES?

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I. INTRODUCTION

What kind of rights do shareholders have in determining executive pay? Traditionally, these rights were extremely limited. However, with the recent passage of the Dodd-Frank Act, shareholders are now empowered to approve a board's executive compensation plan at least once every three years[1] through what is commonly regarded as a "Say-on-Pay" vote. Congress has made clear that this vote is non-binding[2] and neither creates nor implies any new fiduciary duties upon the board of directors.[3] Nevertheless, a string of derivative lawsuits have arisen regarding this newly empowered shareholder vote, in which plaintiff shareholders argue that the business judgment protection of board members should be rebutted by an adverse Say-on-Pay vote.

Four cases have reached final decisions regarding Say-on-Pay votes.[4] Their analysis of how they apply the text of the statute, the business judgment rule, demand futility, and other corporate law concepts will be critically examined in this note. This Note suggests that based on the plain text of the statute, remedies from an adverse Say-on-Pay vote do not lie in derivative litigation. This Note also suggests that claims based on Say-on-Pay votes are impractical. Typically, a board will craft an executive compensation plan and afterwards hold a Say-on-Pay vote. Thus, any executive compensation decision reached by a board, judged

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1. 15 U.S.C.A. § 78n-1(a)(1) (West 2010).
2. *See id.* § 78n-1(c).
3. *See id.* § 78n-1(c)(2).
4. Two cases have addressed Say-on-Pay votes but have essentially sidestepped or otherwise not examined the issue. For the case involving Pico Holdings, Inc., the United States District Court for the Southern District of California did not decide whether the Say-on-Pay vote "should be interpreted or constructed as evidence of a breach of fiduciary duty," because they held that federal courts lacked jurisdiction over the cases. Dennis v. Hart, 724 F.3d 1249, 1251 (9th Cir. 2013). For the case involving defendant corporation Biomed Realty Trust, Inc., the United States District Court for the District of Maryland applied Maryland corporate law to the case, which does not allow an analysis into the merits of the complaint in order to establish pre-suit demand futility, and the plaintiffs otherwise did not establish pre-suit demand futility; thus, the claim was dismissed. Weinberg *ex rel.* BioMed Realty Trust, Inc. v. Gold, 838 F. Supp. 2d 355 (D. Md. 2012).

in light of a Say-on-Pay vote, will clearly suffer from hindsight bias. Lastly, this Note looks at various misapplications of corporate law that have led to a faulty analysis of these claims and why such claims should fail to survive in any jurisdiction.

II. BACKGROUND

In light of the financial collapse of 2008 that affected nearly every facet of the United States' economy, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[5] to address the causes of the collapse and restore confidence in financial markets.[6] Dodd-Frank is the largest expansion of federal power over the market since the Great Depression and covers every aspect of finance from ATM cards to trading regulations.[7] The Act contains provisions regarding executive compensation mandating their regulation through a vote by shareholders, also known as a "Say-on-Pay" vote.[8] However, the vote itself is only advisory and is nonbinding.[9] The legislation also specifically mandates that the vote may not be construed to overrule a decision by a board of directors[10] nor change or "imply any change to the fiduciary duties" of a board.[11]

A. Lawsuits

Since the passing of Dodd-Frank, numerous corporations have had shareholder votes on executive compensation.[12] In some instances, shareholders have voted against proposed executive compensations, yet the boards of directors did not change executive compensation plans in response.[13] This has led shareholders to bring derivative lawsuits arising from their disapproval of the directors' independent actions, actions that these shareholders feel are contrary to the best interest of the corporation.[14]

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5. 15 U.S.C.A. § 78n-1(c).

6. *See* Aaron Luchetti & Damian Paletta, *Law Remakes U.S. Financial Landscape*, WALL ST. J. (July 16, 2010, 12:01 AM), http://online.wsj.com/news/articles/SB10001424052748704682604575369030061839958.

7. *Id.*

8. 15 U.S.C.A. § 78n-1(c).

9. *Id.*

10. *Id.* § 78n-1(c)(1).

11. *Id.* § 78n-1(c)(2).

12. *See* Jason J. Mendro, *Emerging Litigation Over Say on Pay Votes*, INSIGHTS: CORP. & SEC. L. ADVISOR, Aug. 2011, at 19.

13. *See id.* at 21.

14. *Id.* at 19.

To date, there have been at least seven derivative lawsuits out of forty-three corporations with "no" votes.[15] For Delaware corporations, plaintiffs appear to have a preference for filing the lawsuits outside of Delaware.[16] This could be due to the general tendency of Delaware courts to be pro-management; however, due to the internal affairs doctrine, other courts must still apply Delaware law to these corporations even when they have jurisdiction.[17]

Two of the cases have been settled out of court, involving corporations KeyCorp and Occidental Petroleum.[18] Considering the nature of derivative suits, oftentimes a settlement can yield a better result for shareholders than a complete victory in court.[19] If the shareholders do not get a settlement and end up winning the suit, damages still go back

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15. *See id.* at 20.

16. *Id.*

17. *See* Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy, No. 2011-cv-197841, 2011 WL 4836230 (Ga. Super. Ct. Sept. 16, 2011); *see also* 19 C.J.S. *Corporations* § 981 (2013) ("The internal affairs doctrine is a conflict of laws principle which recognizes that only one state should have the authority to regulate a corporation's internal affairs . . . .").

18. *See* Mendro, *supra* note 12, at 28-30. For KeyCorp, the parties reached a settlement for the following terms: (1) adoption of a resolution that "reaffirms its 'pay-for-performance' executive compensation philosophy following repayment of TARP funds"; (2) the compensation committee "would publish 'easy to understand' performance criteria for executive compensation" that is more reader-friendly; (3) an executive may no longer serve on the compensation committee for more than five consecutive years; (4) in awarding future compensation to an executive who received equity awards in 2009 and 2010, the compensation committee would consider the value of those previously issued awards "so that long-term compensation reflects performance"; and (5) 900,000 of KeyCorp's CEO's options that were granted to him in 2009 would now expire in 2015. *Id.* at 29. Additionally, the settlement included all attorney fees for the plaintiffs' counsel, totaling $1.75 million. *Id.*

Occidental Petroleum reached similar terms: (1) compensation for the CEO and the Executive Chairman of the Board would be lowered to a similar level of comparable companies, and the substantial majority of executive pay will be "performance based"; (2) the company would cease giving certain awards and make others based on those of similar levels of comparable companies; (3) a new CEO would be appointed in 2011; (4) shareholders may vote to change the corporation's bylaws in 2014 to split the CEO and Chairman of the Board role; and (5) The board would "clearly explain to shareholders how and why it sets specific compensation targets." *Id.* at 29-30 (quoting Revised Stipulation of Settlement, Resnik v Abraham, No. 10-cv-390-RK (D. Del. 2011)). Occidental Petroleum also agreed to pay for plaintiffs' attorneys' fees totaling more than $1.1 million. *Id.* at 30.

19. The court must approve a settlement in accordance with the Federal Rules of Civil Procedure. Because derivative actions represent all shareholders of the corporation, a settlement must be approved by the court. FED. R. CIV. P. 23.1(c).

into the corporation,[20] but this does not guarantee that a similar problem will not reoccur again in the future. Corporations may also be potentially harmed from the negative publicity when boards pay executives in excess of what their shareholders approve.[21] Therefore, if the problem can be fixed through a settlement, this is often in the best interests of both parties.

Four cases have reached decisions regarding a motion to dismiss by defendant corporations: *NECA-IBEW Pension Fund ex rel. Cincinnati Bell, Inc. v. Cox,*[22] *Teamsters Local 237 Additional Security Benefit Fund v. McCarthy* (regarding defendant corporation Beazer), [23] *Plumbers Local No. 137 Pension Fund v. Davis (*regarding defendant corporation Umpqua), [24] *and Laborers' Local v. Intersil.*[25] All four cases have similar facts, but the court in *Cincinnati Bell* issued a conflicting holding from the cases involving Beazer, Umpqua, and Intersil.

B. "Say-on-Pay" as Applied to Ohio Corporate Law: NECA-IBEW Pension Fund ex rel. Cincinnati Bell, Inc. v. Cox

The court in *Cincinnati Bell* held in favor of the plaintiff when the defendant corporation filed a motion to dismiss.[26] Cincinnati Bell's board granted large bonuses to directors at the same time that there was a decline in net income, earnings per share, and share price.[27] The board

20. In the event of a victorious shareholder in a derivative suit against directors or officers, the directors or officers may have to repay the assets diverted or profits gained from any deal with the corporation or any excessive compensation or any damages caused to the corporation by their negligence or misconduct. *See* Bernstein v. Levenson, 437 F.2d 756, 757 (4th Cir. 1971) ("In a stockholders' derivative action the corporation, not the complaining shareholder, is the real party in interest . . . .") *See also* LAW OF CORP. OFFICERS & DIR.: INDEMN. & INS. § 3:2 (Nov. 2012).

21. *See Executive Pay and Performance*, ECONOMIST (Feb. 7, 2012, 8:59 PM), http://www.economist.com/blogs/graphicdetail/2012/02/focus-0?; *see also* Graef Crystal, *Mike Ovitz Got Away With Murder*, SLATE (Dec. 22, 1996, 3:30 AM), http://www.slate.com/articles/briefing/articles/1996/12/mike_ovitz_got_away_with_murder.html. See Stephen Labaton and Vikas Bajaj, *In Curbing Pay, Obama Seeks to Alter Corporate Culture*, N.Y. TIMES (Feb. 4, 2009), http://www.nytimes.com/2009/02/05/us/politics/05pay.html?pagewanted=all, for a discussion that illustrates public disapproval of excessive executive compensation.

22. No. 1:11-cv-451, 2011 WL 4383368 (S.D. Ohio Sept. 20, 2011).

23. No. 2011-cv-197841, 2011 WL 4836230 (Ga. Super. Ct. Sept. 16, 2011).

24. No. 03:11-633-AC, 2012 WL 104776 (D. Or. Jan. 11, 2012).

25. 868 F. Supp. 2d 838 (N.D. Cal. 2012).

26. *Cincinnati Bell*, 2011 WL 4383368, at *3.

27. The opinion indicated,

> [D]irectors grant[ed] $4 million dollars in bonuses, on top of $4.5 million dollars in salary and other compensation, to the chief executive officer in the same year the company incur[ed] a $61.3 million dollar decline in net

recommended that shareholders approve the 2010 executive compensation; however, it received a sixty-six percent "no" vote from the voting shareholders.[28] Plaintiff shareholders then brought a claim alleging a breach of the duty of loyalty[29] against the board, citing, *inter alia*, the overwhelming rejection by shareholders of the 2010 executive compensation plan.[30]

Traditionally, shareholders had no say in executive compensation (unless the articles of incorporation or bylaws provided for such or the shareholders voted to change the articles or bylaws to provide for such).[31] Essentially, they could only attempt to overrule board actions through litigation by alleging some wrongfulness of the board of directors, most often alleging a breach of their fiduciary duties to the corporation. There are two separate fiduciary duties required of directors: the duty of loyalty and the duty of care.[32] However, boards of directors are protected by the "business judgment rule" when making decisions regarding executive compensation, and courts "will not inquire into the wisdom of actions taken by a director in the absence of fraud, bad faith, or abuse of discretion."[33]

In *Cincinnati Bell*, the court applied Ohio corporate law because the defendant was an Ohio corporation.[34] The court followed an approach

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> income, a drop in earnings per share from $0.37 to $0.09, a reduction in share price from $3.45 to $2.80, and a negative 18.8% annual shareholder return.

Id at *1.

28. *Id.*

29. See *infra* note 32 for a definition of the duty of loyalty.

30. *Cincinnati Bell*, 2011 WL 4383368, at *1.

31. Although often faced with extreme board resistance, countless options are available for shareholder proposals, ranging from recommendations to the board regarding executive compensation to voting out defiant board members, as long as the proposals are in accordance with the regulations associated with the Securities and Exchange Act of 1934, 17 C.F.R. § 240.14a-8 (2011). *See* Lee Harris, *The Politics of Shareholder Voting*, 86 N.Y.U. L. REV. 1761, 1769 (2011) (discussing the power of shareholder voting); *see also* Roberta Romano, *Less Is More: Making Institutional Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 201 (2001) (identifying that executive compensation accounts for 10% of shareholder proposals).

32. *See* Radol v. Thomas, 772 F.2d 244, 256 (6th Cir. 1985). The duty of loyalty requires directors perform their duty "in good faith in a manner [the director] reasonably believes is in the best interest[s] of the corporation." *See id.* (quoting OHIO REV. CODE ANN. § 1701.59(B) (West 2012)) (internal quotation marks omitted). The duty of care requires that "a director must perform his duties with the care that an ordinary prudent person in a like position would use under similar circumstances." *Id.*

33. *Id.* at 257 (quoting OHIO REV. CODE ANN. § 1701.59(B)) (internal quotation marks omitted).

34. *Cincinnati Bell*, 2011 WL 4383368, at *3-4.

foreign to Delaware law (which the Beazer, Umpqua, and Intersil cases followed), that "the business judgment rule imposes a burden of proof, not a burden of pleading."[35] The court held that plaintiff shareholders adequately pleaded a claim for a breach of fiduciary duty by alleging that the board approved pay hikes for executives while the company was declining in financial performance and did not follow the company's pay-for-performance compensation policy.[36] This was deemed not in the shareholders' best interest (citing the Say-on-Pay vote as direct probative evidence), which thus "constituted an abuse of discretion and/or bad faith."[37] At trial, defendants may offer the affirmative defense of the "business judgment rule," which in turn requires plaintiffs to prove either the board's "intent to cause harm to the corporation" or "reckless disregard" for the corporation's best interests.[38] However, under Ohio law, this defense does not come into play until after the pleading stage.[39]

The defendant corporation in *Cincinnati Bell* also raised the defense that plaintiffs did not first make a demand to the directors to bring suit against themselves.[40] Under Ohio law, the directors are unable to initiate any suit on behalf of the corporation unless the plaintiffs make such a demand.[41] However, Ohio law also permits plaintiffs to bring a suit if

35. *Id.* at *2 (citing *In re* Nat'l Century Fin. Enters., Inv. Litig., 504 F. Supp. 2d 287, 312 (S.D. Ohio 2007); Marsalis v. Wilson, 778 N.E.2d 612, 616 (Ohio Ct. App. 2002)).

36. Although the failure of *Cincinnati Bell* to follow its compensation policy is not the focus of this note, it is interesting to examine how the court analyzes this accusation. The compensation policy states that at-risk compensation should be "tied to the achievement of specific short-term and long-term performance objectives, principally the Company's earnings, cash flow, and the performance of the Company's common shares, thereby linking executive compensation with the returns realized by shareholders." *Cincinnati Bell,* 2011 WL 4383368, at *3 n.3 (emphasis omitted). The court held that the board violated the company's policy by paying excessive compensation while shareholders received a loss in the same year but completely ignored that the policy specifically stated compensation should be tied to both "short-term *and long-term performance objectives.*" *Id.* (emphasis added).

37. *Cincinnati Bell,* 2011 WL 4383368, at *3.

38. *Id.*

39. *Id.* It is important to note that shifting the burden to apply at summary judgment or trial, rather than at pleading, allows the case to continue to discovery. This will effectively open all the corporation's books relevant to the litigation (which makes it much more likely that a plaintiff will find more evidence to prove a breach of a fiduciary duty).

40. *Id.* Essentially, not demanding a board of directors to sue themselves is a tactical one. After making a demand to sue, if the board chooses not to sue itself, plaintiffs must then prove that the board's decision not to sue itself was wrongful, a much more difficult standard than proving that demand was futile. *See* McCall v. Scott, 239 F.3d 808, 816 (6th Cir. 2001); *see also* Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993).

41. OHIO R. CIV. P. 23.1.

they can demonstrate that pre-suit demand would have been futile.[42] "[D]emand is presumptively futile 'where the directors are antagonistic, adversely interested, or involved in the transactions attacked.'"[43] Also, suing an entire board of directors may establish demand futility.[44] In this case, all directors were named as defendants because they were the same directors who approved the 2010 executive compensation plan, with the exception of one current director who was elected after the approval of the compensation plan.[45] Regardless, the court held that this would still be considered a scenario where *all* the directors were named, and because all the director defendants are the same directors who approved the compensation packages, "there is reason to doubt these same directors could exercise their independent business judgment over whether to bring suit against themselves for [a] breach of fiduciary duty in awarding the challenged compensation."[46] Therefore, pre-suit demand was futile, and the court denied the defendants' motion to dismiss.[47]

C. "Say-on-Pay" as Applied to Delaware Corporate Law

Like *Cincinnati Bell*, shareholders challenged defendant corporations Beazer,[48] Umpqua,[49] and Intersil[50] in derivative suits because executives were getting pay hikes while the corporations suffered net losses, and the shareholders voted against executive compensation proposals in their respective Say-on-Pay votes.

Despite being in three different courts, each court applied Delaware corporate law due to the Internal Affairs Doctrine.[51] Under Delaware

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42. *See* Carlson v. Rabkin, 789 N.E.2d 1122, 1128 (Ohio Ct. App. 2003).

43. *Cincinnati Bell*, 2011 WL 4383368, at *4 (citing *In re* Ferro Corp. Derivative Litig., 511 F.3d 611, 618 (6th Cir. 2008)).

44. *Id.* at *4 n.5.

45. *Id.*

46. *Id* at *4.

47. *Id.* It should be noted that there has since been jurisdictional challenges to whether or not the federal court in this case has diversity jurisdiction, and at this point, it is unclear whether the case will actually proceed to trial or be removed to state court. *See Cincinnati Bell*, 2011 WL 4383368.

48. Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy, No. 2011-cv-197841, 2011 WL 4836230 (Ga. Super. Ct. Sept. 16, 2011).

49. Plumbers Local No. 137 Pension Fund v. Davis, No. 03:11-633-AC, 2012 WL 104776 (D. Or. June 11, 2012).

50. Laborers' Local v. Intersil, 868 F. Supp. 2d 838 (N.D. Cal. 2012).

51. Beazer and Intersil are Delaware corporations, and thus Delaware law was applied. *Teamsters*, 2011 WL 4836230; *Intersil*, 2012 WL 762319, at *4. Umpqua is an Oregon company; however, Oregon follows the law of Delaware for guidance regarding corporate law, and thus the Umpqua court followed the same framework as the Beazer and Intersil cases. *Plumbers*, 2012 WL 104776, at *8.

law, the "business judgment rule" is applied at pleading, fitting into the requirements of proving pre-suit demand futility.[52] In order to prove demand futility, a plaintiff must meet the two-prong *Aronson* test by alleging facts that create a reasonable doubt that "(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[53] The business judgment rule can be rebutted by pleading "particularized facts sufficient to raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision."[54]

1. Teamsters Local 237 Additional Security Benefit Fund v. McCarthy ("Beazer")

Defendant corporation Beazer, after executives had received pay hikes despite the company incurring a net loss,[55] received a fifty-four percent Say-on-Pay vote against their executive compensation plan.[56] In turn, plaintiff shareholders brought an action alleging a breach of the directors' fiduciary duties (among other claims), and defendants in turn filed a motion to dismiss.[57] The court granted the motion to dismiss on multiple grounds, including the plaintiffs' "lack of standing to assert these claims derivatively on Beazer's behalf due to [the] [p]laintiffs' failure to allege contemporaneous and continuous ownership of Beazer stock"; the plaintiffs' "fail[ure] to properly allege [a] legal excuse for their failure to make a pre-suit demand"; and the plaintiffs' "fail[ure] to state a claim upon which relief may be granted."[58]

The corporation's Say-on-Pay vote was analyzed in accordance with demand futility, and the plaintiffs only challenged it under the second prong of the *Aronson* test, alleging the adverse shareholder vote rebuts the "business judgment rule" because the decision was not in the shareholders' best interests.[59] However, the court found this argument

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52. *See* Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).
53. *Id.*
54. *Plumbers*, 2012 WL 104776, at *6 (citing *In re* J.P. Morgan Chase & Co. S'holder Litig., 906 A.2d 808, 824 (Del. Ch. 2005)).
55. The 2010 executive compensation plan "involved pay raises for the Company's four most highly compensated executives, even though the Company suffered a net loss of $34 million and an annual share price return of (-17.23%) for fiscal 2010." *Teamsters*, 2011 WL 4836230.
56. *Id.*
57. *Id.*
58. *Id.*
59. *Id.*

unpersuasive, both factually and legally.[60] For one, Beazer's board of directors could not have taken into account the results of the shareholder vote because the board created the compensation plan prior to the occurrence of the shareholder vote.[61] Secondly, the express language of Dodd-Frank states the vote is not binding upon the board of directors and does not change or create any fiduciary duties upon the board.[62] Because the federal legislation does not change the existing fiduciary duties, Delaware law remains the controlling standard, which provides wide discretion be given to the board to set executive compensation.[63] Therefore, the court held the adverse Say-on-Pay vote *alone* does not rebut the business judgment rule.[64]

The plaintiffs in the *Beazer* case also challenged the board's decision to not rescind the compensation packages after the shareholders voted against them.[65] However, the court pointed out that the language in Dodd-Frank expressly states the Say-on-Pay vote is non-binding.[66] Additionally, the plaintiffs provided no basis for how the compensation plans could be rescinded.[67] The plaintiffs would have had to rebut the business judgment rule on the board's decision to take away compensation that executive officers had already earned.[68] The plaintiffs failed to do this and thus did not rebut the business judgment rule for this allegation.[69]

2. *Plumbers Local No. 137 Pension Fund v. Davis ("Umpqua")*

In the *Umpqua* case,[70] a compensation committee set executive compensation.[71] Executive compensation went up sixty to one hundred

60. *Id.*
61. *Teamsters*, 2011 WL 4836230.
62. *Id.* (citing 15 U.S.C. § 78n-1(c) (2010)).
63. *See* Brehm v. Eisner, 746 A.2d 244, 262 n.56 (Del. 2000); *see also* Aronson v. Lewis, 473 A.2d 805, 817 (Del. 1984); Haber v. Bell, 465 A.2d 353, 359 (Del. Ch. 1983) (observing that "generally directors have the sole authority to determine compensation levels"); DEL. CODE ANN. tit. 8, § 122(5) (West 2011); Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 799 (Del. Ch. 2004) (observing that "[i]nformed decisions regarding employee compensation by independent boards are usually entitled to business judgment rule protection").
64. *Teamsters*, 2011 WL 4836230.
65. *Id.*
66. *Id.* (citing 15 U.S.C. § 78n-1(c)).
67. *Id.*
68. *Id.*
69. *Id.*
70. Plumbers Local No. 137 Pension Fund v. Davis, No. 03:11-633-AC, 2012 WL 104776 (D. Or. Jan. 11, 2012).
71. *Id.* at *1.

percent and sixty percent for each of the individual directors; in the same year, shareholders netted a negative return.[72] The board of directors recommended the compensation plan to shareholders in 2011 and held the mandatory Say-on-Pay vote, during which shareholders rejected the plan sixty-two to thirty-five percent, with three percent abstaining.[73] The board then said in the future it would "more closely link executive compensation to stock price and dividend performance."[74]

The *Umpqua* case, like *Beazer*, again turned on demand futility and the two-prong *Aronson* test.[75] The plaintiffs in *Umpqua* alleged that demand was futile on both *Aronson* prongs.[76] On the first prong, the plaintiffs did not argue that the board members were interested in the action under a traditional view,[77] but that they were interested because they faced liability for a breach of their fiduciary duties and would thus not be objective in bringing a suit against themselves.[78] The plaintiffs relied on *Cincinnati Bell* as authority.[79] However, the court rejected the reasoning of *Cincinnati Bell*, stating that the logic was circular and unpersuasive;[80] thus, the *Umpqua* plaintiffs failed to satisfy the first prong of the *Aronson* test.[81]

For the second prong, the plaintiffs argued that because the shareholder vote showed that the compensation plan was not in the corporation's or the shareholders' best interests, the burden shifted, and

72. *Id.* at *2. Umpqua received a capital investment from the United States Treasury Department in 2008, and as a condition of which, it had to accept executive compensation limits in 2009 and 2010. *Id* at *1. In 2010, after the executive compensation limits were lifted, the compensation committee decided to "normalize" compensation using executive compensation and benchmarking studies, and the committee changed the executive compensation plans. *Id.*

73. *Id.* at *1.

74. *Plumbers*, 2012 WL 104776, at *2.

75. *Id.* at *3-4.

76. *Id.*

77. Typically, an "interest" is when the director or officer either receives a benefit from the transaction not generally shared by other shareholders, and the benefit is of such material significance that it would be reasonable to question whether the officer considered the transaction objectively, or, alternatively, when the director or officer stands on both sides of the transaction. *See* Orman v. Cullman, 794 A.2d 5, 23 (Del. Ch. 2002).

78. *Plumbers*, 2012 WL 104776, at *5.

79. *Id.*

80. "Under Plaintiffs' reasoning, the fact that presuit demand is itself suggestive of impending liability is sufficient to create the type of self-interest that triggers the demand futility exception. This would permit every derivative action plaintiff to argue that demand is futile and need not be made because no board would be able to act objectively in evaluating a presuit demand." *Id.*

81. *Id.* at *6.

thus the defendants should then had to prove their decision was based on rational business judgment.[82] The defendants contended the Say-on-Pay vote, in accordance with the Dodd-Frank Act, did not overrule a board decision, change any fiduciary duties, nor create any new fiduciary duties.[83] Rather, shareholder opinions are only advisory on the board of directors, and disagreement does not exempt business judgment protection.[84] The court agreed with the defendants and concluded that the business judgment rule was not overcome on this basis because the board did not "defy or violate any Umpqua bylaw, any shareholder agreement, or any legally mandated disclosure or reporting requirement."[85]

3. *Laborers' Local v. Intersil*

Defendant corporation Intersil's board of directors raised executive compensation by an average of forty-one percent in 2010, based on the company's "pay for performance" policy.[86] In the same year, the company had declines in both net income and earnings per share.[87] Shareholders disapproved of the board's 2010 executive compensation plan in their Say-on-Pay vote, with fifty-six percent voting "no."[88] A derivative lawsuit was subsequently filed alleging a breach of fiduciary duty and unjust enrichment against the board of directors and current executives, claiming that the compensation approved was "excessive, irrational, and unreasonable" and the corporation continues to be injured by the amounts of executive pay.[89]

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82. *Id.* at *7.

83. *Id.* (citing 15 U.S.C. § 78n-1(c) (2010)).

84. *Plumbers*, 2012 WL 104776, at *7.

85. *Id.* Essentially, the court was glossing over the plaintiffs' actual argument, which was that it is impossible to say the directors were acting in the best interests of the shareholders when the shareholders themselves expressed their disagreement through the Say-on-Pay vote. *Id.* The court did not really address this argument but instead rested its holding on the actual text of the Dodd-Frank Act, which created no new legal ramifications. *Id.* (citing 15 U.S.C. § 78n-1(c)). The plaintiffs in the Umpqua case also used other theories, such as if the compensation plan was inconsistent with general corporate performance, it would rebut the business judgment rule, and pay-for-performance is a standard that should be followed for compensation. *Id.* The court dismissed plaintiffs' allegations as merely conclusory and "not sufficient to create a reasonable doubt that the board took this action honestly and in good faith or to show that it was adequately informed in making the decision, thus overcoming the presumption." *Id.*

86. Laborers' Local v. Intersil, 868 F. Supp. 2d 838 (N.D. Cal. 2012).

87. *Id.* at 842.

88. *Id.*

89. *Id.*

Again, the case fell upon the two-prong *Aronson* test.[90] Under the first prong, the plaintiffs used similar arguments to those raised in the *Umpqua* and *Cincinnati Bell* cases, alleging that the board faced a substantial likelihood of liability because of its breach of fiduciary duties in regard to the 2010 executive compensation plan, and thus the board may not act with independent business judgment in regard to bringing a suit against themselves.[91] The court rejected this argument, stating, "A plaintiff may not 'bootstrap allegations of futility' by pleading merely that 'the directors participated in the challenged transaction or that they would be reluctant to sue themselves,'"[92] and held that the plaintiffs did not meet their burden of proving that a majority of directors were interested or not independent.[93]

For the second prong of the *Aronson* test, the plaintiffs claimed that the adverse Say-on-Pay vote "is evidence showing that directors failed to act in the shareholders' best interest and rebuts the presumption that the Board's decision regarding compensation is entitled to business judgment protections."[94] The court went into a lengthy discussion of what the Say-on-Pay vote was intended for, examining the text of the statute as well as some statements by members of Congress from congressional hearings regarding Dodd-Frank.[95] In the end, the court concluded that "the Act is silent on what consideration courts should give the shareholder vote," but based on the legislative history, Congress clearly intended the vote to have some effect.[96] Thus, the court held that the vote itself could be considered as "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."[97] However, like *Beazer*, the court held that the shareholder vote by itself is not enough to rebut the business judgment protection of a board.[98] Because plaintiffs failed to plead other facts to rebut the business judgment rule, they failed to meet the second prong of the *Aronson* test and thus could not prove that demand was futile, and the claim was dismissed.[99]

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90. *Id.* at 845 (citing Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984)).
91. *Id.*
92. *Intersil*, 868 F. Supp. 2d at 845 (quoting Blasband v. Rales, 971 F.2d 1034, 1049 (3d Cir. 1992)).
93. *Id.*
94. *Id.* at 847.
95. *Id.* at 848-49.
96. *Id.*at 849.
97. *Id.*
98. *Intersil*, 868 F. Supp. 2d at 849.
99. *Id.*at 849-50.

III. ANALYSIS

The *Beazer*,[100] *Umpqua*,[101] and *Intersil*[102] cases offer some guidance on Say-on-Pay votes in regard to director breaches of fiduciary duties and rebutting the business judgment rule. Regardless, Say-on-Pay "no" votes have led to suits for numerous corporations.[103] In order to understand why, it must first be understood how directors make decisions and how the statute has changed corporate behavior.

A. Why "Say-on-Pay" is Confusing

When a board of directors needs to create or change an executive compensation plan, typically the board first conducts a compensation analysis.[104] After this, it will base its compensation policy and compensation plan on that analysis. Sometime after, the plan is implemented, and the shareholders vote to approve or disapprove of the compensation plan, although the statute is silent as to whether the plan must be voted on before or after it is actually implemented.[105] Regardless of which comes first, the statute expressly states that the vote will not overrule a decision of the board.[106]

It is clear from the legislative history of the Act that the Say-on-Pay vote is not meant to be completely meaningless and is meant to grant some kind of power to shareholders. Senator Barney Frank stated during a hearing before the House Committee on Financial Services that the

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100. Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy, No. 2011-cv-197841, 2011 WL 4836230 (Ga. Super. Ct. Sept. 16, 2011).

101. Plumbers Local No. 137 Pension Fund v. Davis, No. 03:11-633-AC, 2012 WL 104776 (D. Or. June 11, 2012).

102. *Intersil*, 868 F.Supp. 2d at 838.

103. *See* Mendro, *supra* note 12, at 19.

104. It is not necessary for a board to hire a compensation committee; however, the board does have a duty to become aware of all "material facts that are reasonably available" in regard to its decision. Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000) (emphasis omitted). Relying on experts is a sufficient way to become aware of all material facts. DEL. CODE ANN. tit. 8, § 141 (West 2010).

105. Considering that the statute provides that there may be a shareholder vote only once every three years, the legislature obviously contemplated that these plans would often be implemented before the Say-on-Pay votes were conducted. *See* 15 U.S.C.A. § 78n-1(a)(1) (West 2010). Congress could have fashioned the Say-on-Pay provision to require a board to create a draft executive compensation plan and submit it to the shareholders for approval, being implemented upon a vote of approval by the shareholders. But alas, this is not what the statute prescribes.

106. *Id.* § 78n-1(c)(1).

"say on pay" provision was passed "to empower the shareholders,"[107] and Senator Jack Reed on the Senate floor stated that the shareholder vote was intended to give shareholders "the ability to hold executives accountable, and to disapprove of misguided incentive schemes."[108]

The lingering question remains: what, if any, remedy lies for shareholders when they have given a "no" vote for executive compensation? Clearly, if the vote cannot overrule the decision of the board of directors,[109] or create or imply any change in the fiduciary duties of the board of directors,[110] the answer is not in litigation. Rather, the statute hints at what a remedy might look like, stating, "The shareholder vote . . . may not be construed . . . to restrict or limit the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation."[111] The statute is clearly emphasizing that shareholders are left with the option to call proxy votes to change executive compensation to a pay-for-performance model.[112] Additionally, the vote brings an additional deterrence for board directors to make executive pay linked to shareholder returns because a negative shareholder vote will adversely impact the publicity and morale of the corporation.[113]

That is the kind of impact that the Say-on-Pay vote was supposed to have according to the letter of the law given by Congress.[114] However, things get muddled when shareholders (or plaintiff-side law firms) realize from the Say-on-Pay "no" vote that the board has granted executive compensation that is out of sync with shareholder returns and thus decide to bring litigation. While the Say-on-Pay statute was not designed to give a cause-of-action for shareholders, it is nevertheless used as a vehicle to allege a breach of fiduciary duties.[115]

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107. *Executive Compensation Oversight after the Dodd-Frank Wall Street Reform and Consumer Protection Act: Hearing Before the H. Comm. on Financial Services*, 111th Cong. 3 (2010), *available at* http://financialservices.house.gov/media/pdf/111-160.pdf (statement of Rep. Barney Frank, Chairman, H. Comm. on Financial Services).

108. 156 CONG. REC. S5916 (daily ed. July 15, 2010) (statement of Sen. Jack Reed).

109. 15 U.S.C.A. § 78n-1(c)(1).

110. *See id.* § 78n-1(c)(2)-(3).

111. *See id.* § 78n-1(c)(4).

112. *See* Harris, *supra* note 31.

113. See *Executive Pay and Performance, supra* note 21, for examples.

114. *See* 15 U.S.C.A. § 78n-1(c)(4).

115. It is conceivable that a Say-on-Pay "no" vote would draw attention to a possible breach of fiduciary duties by the board of directors. However, an action of the board that breaches a fiduciary duty, for example, the duty of care, could happen regardless of whether shareholders were receiving positive or negative returns. What is essential is that particularized facts involving a breach of fiduciary duty are alleged. NECA-IBEW Pension Fund *ex. rel.* Cincinnati Bell, Inc. v. Cox, No. 1:11–cv–451, 2011 WL 4383368,

B. Does Say-on-Pay Impact the Business Judgment Rule?

The courts in *Beazer*, *Umpqua*, and *Intersil* began to examine the imperative point of whether Say-on-Pay votes will carry any weight in rebutting the business judgment rule. The *Beazer* court was the first to hold that "an adverse say on pay vote *alone* [does not suffice] to rebut the presumption of business judgment protection."[116] Through its choice of wording, the court left the question open as to whether the Say-on-Pay vote should be afforded as any evidence *at all* in rebutting the business judgment rule. When the *Intersil* court addressed this, the court held that the Say-on-Pay vote should be given *some* evidentiary weight to rebut the business judgment rule because Congress clearly intended Say-on-Pay to grant some shareholder power.[117] The *Umpqua* court sidestepped this issue and instead went to the heart of the matter, stating that "shareholder disagreement with a board's decision does not exempt the decision from the business judgment rule,"[118] and resting its holding on the fact that the board did not break any laws or defy any of the corporation's bylaws.[119]

To afford the Say-on-Pay vote any evidentiary weight in rebutting business judgment protection of a board of directors is just as nonsensical as giving it the power to rebut the business judgment rule. Nowhere in the statute is it stated or implied that the vote may help to rebut the business judgment rule.[120] On the contrary, the statute states that the vote should not change anything in regard to fiduciary duties;[121] because the business judgment rule is a fundamental component of the protection of board members in cases involving a breach of fiduciary duties, the vote should also not change anything in regard to business judgment protection.

at *2 (S.D. Ohio Sept. 20, 2011) (quoting Bell Atl. Corp. v. Twombly, 550 U.S. 544, 556 (2007)). Because a "no" vote does not constitute a breach of a fiduciary duty, a shareholder wishing to bring a derivative suit would have to find facts that do amount to a breach of a fiduciary duty. Of course, these could be found by the same methods of any typical derivative suit. The "no" vote is just a motivating factor to actually look into a derivative action.

116. Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy, No. 2011-cv-197841, 2011 WL 4836230 (Ga. Super. Ct. Sept. 16, 2011).

117. Laborers' Local v Intersil, 868 F. Supp. 2d 838, 849 (N.D. Cal. 2012).

118. Plumbers Local No. 137 Pension Fund v. Davis, No. 03:11-633-AC, 2012 WL 104776, at *7 (D. Or. June 11, 2012).

119. *Id.*

120. *See* 15 U.S.C.A. § 78n-1(c) (West 2010).

121. *See id.* § 78n-1(c)(2).

According to Delaware law, boards of directors are entitled great deference in regard to setting executive compensation.[122] This is because boards are left with the task of managing the corporation, which includes setting the amounts of executive compensation in a manner that they believe would yield the most profit for their corporation and its shareholders.[123] Because of this, boards routinely hire experts or appoint compensation committees to make sure that their compensation decisions are the most beneficial to the corporation.[124]

While it is feasible that some shareholders of a corporation may be fully in tune with their company, and may even be educated analysts who understand how executive compensation should be allocated, while they are in their role as shareholders, they are not in the position to be making those types of decisions. That is because executive compensation decisions are left solely for the board to decide.[125] Affording a shareholder vote as evidence to rebut business judgment protection of a board in regard to executive compensation subtracts from the deference to which boards are entitled. Thus, using the shareholder vote as evidence to rebut the business judgment rule *effectually* gives shareholder votes some degree of binding power in compensation decisions, which is clearly barred by the language of the statute itself.[126]

Additionally, Say-on-Pay votes are usually tainted with hindsight bias. The Say-on-Pay vote is typically conducted well after the executive compensation plans have already been approved by the board and have been in effect for some time (although this is not a requirement).[127] In situations where it turns out that executive compensation has increased while the company has declined in performance, of course shareholders

122. *See* Brehm v. Eisner, 746 A.2d 244, 263-64 (Del. 2000).

123. *See Plumbers*, 2012 WL 104776, at *6.

124. *See generally Brehm*, 746 A.2d 244 (discussing the ability of boards to utilize compensation committees).

125. *See Plumbers*, 2012 WL 104776, at *6.

126. 15 U.S.C.A. § 78n-1(c).

127. If the vote takes place before the compensation plan is binding or is implemented, a board can still fall back on the defense that the statute prescribes that the vote be nonbinding and cannot change or imply any new fiduciary duties. *Id.* § 78n-1(c).

The counterargument is that a board in this hypothetical situation should at least consider the vote as part of the information they use to change the compensation plan thereafter, or else they may breach their fiduciary duties. See *supra* note 32 for an explanation of the duty of loyalty and the duty of care. The counterargument would still be that the statute clearly states that the vote does not change fiduciary duties, and if the vote does not change fiduciary duties, neither should the result of the vote. It would be a strange rule to be silent on whether the vote should be before or after a compensation plan is binding or implemented and the board to subject itself to potential litigation only if it chooses the more responsible option of getting shareholder feedback before the compensation plan is binding or implemented.

would be more inclined to vote against the compensation plan because executive officers are receiving a higher income despite the shareholders receiving lower profits.[128] However, at the time the board approves an executive compensation plan, there is no way of knowing for sure how the company will subsequently perform.[129] A board of directors should only have to base their decisions on the information they know at the present time they make those decisions,[130] and it is not fair to hold them accountable for unfortunate occurrences of the company that they could not have foreseen. As the *Beazer* court noted, "Hindsight second-guessing and Monday morning quarterbacking of the sort Plaintiffs urge are fundamentally inconsistent with the business judgment analysis."[131]

C. Will Courts Continue Using an Analysis Similar to Cincinnati Bell?

Unfortunately, one of the first cases decided on this matter was *Cincinnati Bell*,[132] which applied Ohio law (albeit incorrectly) to the facts and denied a motion to dismiss.[133] This occurred for two principle reasons: (1) the unique interpretation of the demand requirement[134] and (2) the unique understanding of the business judgment rule.[135]

When the *Cincinnati Bell* court decided whether the demand of the board was futile, it cited two reasons: one, that the directors could not have made "unbiased, independent business judgments about whether to sue,"[136] and two, that the director defendants were the same directors that approved the compensation plan.[137] Strangely enough, Ohio courts "'have consistently rejected the idea that demand is always futile when the directors are targeted as the wrongdoers of the suit the shareholders

128. *See* Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1022 (1999).

129. Even if the board is aware that the company is presently performing poorly, it may have long-term profit goals in mind and be of the opinion that raising executive compensation is exactly what is needed to turn the company around.

130. While the board has the requirement to be aware of all material facts, it also has some leeway with the business judgment rule to make decisions within reasonable business judgment. *See* Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000); *Plumbers*, 2012 WL 104776, at *3.

131. Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy, No. 2011-cv-197841, 2011 WL 4836230 (Ga. Super. Ct. Sept. 16, 2011).

132. NECA-IBEW Pension Fund *ex. rel.* Cincinnati Bell, Inc. v. Cox, No. 1:11-cv-451, 2011 WL 4383368 (S.D. Ohio Sept. 20, 2011).

133. *Id.* at *5.

134. *Id.* at *3.

135. *Id.* at *2.

136. *Id.* at *4.

137. *Id.*

wish the corporation to bring.'"[138] There is no mention of the directors being interested in the transactions monetarily. They were only adversely interested to the extent that they would have had to sue themselves;[139] however, as previously mentioned, just because a futility lawsuit targets directors does not automatically establish demand futility.[140]

Ohio case law, however, allows for some leeway, providing that when *all* directors are named as defendants you may presume demand futility.[141] In this case, there was one existing board member that was not involved in voting on the plan, and he was not included as a defendant in the case.[142] The *Cincinnati Bell* court then shifted its reasoning to say that naming *all* directors really means naming a *majority*, a perspective completely novel to Ohio law.[143] Thus, the decision regarding demand futility was contrary to precedent and probably should have been or will be overturned on appeal.[144]

In regard to the business judgment rule, the court noted that under Ohio law, "the business judgment rule imposes a burden of proof, not a burden of pleading."[145] However, a plea must still contain "factual content that allows . . . the reasonable inference that the defendant is liable for the misconduct alleged."[146] The factual allegations here were the Say-on-Pay vote and a violation of Cincinnati Bell's pay-for-performance policy.[147] The court held that the board's compensation decisions, in view of the Say-on-Pay "no" vote, were "not in the best interests of Cincinnati Bell's shareholders and therefore constituted an abuse of discretion and/or bad faith."[148]

Despite the business judgment rule being a burden of proof and not a burden of pleading under Ohio law, it still must be rebutted with factual

138. *Cincinnati Bell*, 2011 WL 4383368, at *4 (quoting *In re* Ferro Corp. Derivative Litig., 511 F.3d 611, 618 (6th Cir. 2008)).

139. *See supra* note 77 and accompanying text.

140. See discussion *supra* notes 70-85 and accompanying text for the *Umpqua* analysis.

141. *Cincinnati Bell*, 2011 WL 4383368, at *4 n.5 (citing Carlson v. Rabkin, 789 N.E.2d 1122, 1128 (Ohio Ct. App. 2003)).

142. *Id.*

143. *Id.*

144. See *supra* note 47 for the unforeseeable future of this case.

145. *Cincinnati Bell*, 2011 WL 4383368, at *2 (citations omitted) (internal quotation marks omitted).

146. *Id.* at *2 (quoting Bell Atl. Corp. v. Twombly, 550 U.S. 544, 556 (2007)) (internal quotation marks omitted).

147. *Id.*; *see supra* note 36 and accompanying text. If long-term performance objectives are included in the policy, how does evidence that only shows results in the short-term violate this policy?

148. *Id.*

allegations.[149] The factual allegation that the Say-on-Pay vote was a "no" does not surmount to the board's compensation decision being against the best interest of shareholders, nor does it constitute an abuse of discretion and/or bad faith. Whether the board made a decision in the best interests of shareholders and did not abuse its discretion or act in bad faith has to be judged in the context of what the board knew at the time it was making its decision. A Say-on-Pay vote that is nonbinding by the terms of the statute itself and that typically suffers from hindsight bias, thus, should not fit into this analysis.[150] The court glossed over this and again ruled incorrectly.[151]

Conceivably, under Ohio law, a case could arise in which all defendant directors voted on an executive compensation plan and all are named as defendants, and thus it will meet the demand futility requirement and the court will be free to analyze the merits of the case. Similarly, it might be possible that in other courts with other choices of law, in instances when plaintiffs can overcome these common pleading hurdles, the case will continue on to the merits of whether Say-on-Pay rebuts the business judgment rule. Despite this, the more recent trend of Say-on-Pay cases have held that there should never be a circumstance in which a Say-on-Pay vote *alone* will rebut the business judgment rule. As the case law develops, and courts further understand that consideration of Say-on-Pay votes distorts business judgment protections, courts should no longer factor in Say-on-Pay votes to rebut the business judgment rule *at all.*

IV. CONCLUSION

Dodd-Frank's Say-on-Pay provision does not provide a cause of action for shareholders in derivative litigation, nor should it be used as evidence to rebut the business judgment rule. Rather, the Say-on-Pay provision allows shareholders to give a board notice of their approval or disapproval of the board's compensation plans, and the remedies for "no" votes lie in shareholder proposals and the risks of the company receiving negative publicity.

It is impossible for a board when making executive compensation decisions to consider a Say-on-Pay vote by shareholders when the vote takes place after the board has made its executive compensation decisions. A board is free to use its own business judgment in making executive compensation decisions, and its business judgment is based on

149. *Id.* at *2 (quoting *Twombly,* 550 U.S. at 556).
150. *See supra* notes 122-31 and accompanying text.
151. *Cincinnati Bell,* 2011 WL 4383368, at *3.

the information the directors knew at that time. Thus, a court, regardless of jurisdiction and when it is applying the business judgment rule (whether applying it at pleading, in the context of demand futility, or in the breach of a fiduciary duty analysis), should not consider a Say-on-Pay vote to overcome business judgment protection.