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BNA Insights

Executive Compensation

'Cincinnati Bell' and 'Beazer': What Do These Opposite Say-on-Pay Decisions Bode for the Future?

BY LAURA G. THATCHER

The board of directors of Cincinnati Bell (and boards all across America) got a curve ball in September, in the form of the first court decision to allow a shareholder derivative ''say-on-pay'' lawsuit to survive a motion to dismiss. The opinion, issued by a federal court in Ohio, is a particular eye-opener in that it calls into question the cornerstone protection of the business judgment rule and seems to ignore the express provisions of the law providing for the say-on-pay vote itself.

In another notable say-on-pay lawsuit decision, rendered just five days before the *Cincinnati Bell* ruling, a state court in Georgia, applying Delaware law, dismissed a substantially similar lawsuit against directors, consultants, and officers of Beazer Homes.

These two ''book-end'' decisions raise important questions about what boards can expect going forward and, at a minimum, raise the stakes for settlement negotiations in say-on-pay lawsuits.

Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the ''Dodd-Frank Act'') was the culmination of a year-long firestorm of congressional, regulatory, and public reaction to the financial meltdown of 2008. While many factors came together to create the perfect storm, there was always the sense that executive compensation practices and flawed corporate governance were somewhere near the root of the problem. Ultimately, embedded in the more than 2,300 pages of the Dodd-Frank Act are about a dozen provisions addressing executive compensation and corporate governance reforms. Foremost among these is a non-binding, advisory shareholder vote on the compensation paid to the company's named executive officers, as disclosed in the proxy statement.

These two 'book-end' decisions raise important questions about what boards can expect going forward and, at a minimum, raise the stakes for settlement negotiations in say-on-pay lawsuits.

This vote, popularly referred to as ''say-on-pay,'' was designed to intensify the voice of shareholders and increase board accountability for compensation decisions. However, Dodd-Frank pointedly did not hand over the reins to shareholders entirely. The express terms of the Dodd-Frank Act provide that the shareholder say-on-pay vote ''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 the 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.''

Say-on-Pay Lawsuits

In 2010, when fewer than 500 U.S. companies had management say-on-pay proposals on the ballot, three companies failed to receive majority support, and two of these (Occidental Petroleum and KeyCorp) were sued by their shareholders as a result.

In 2011, of the approximately 3,000 public companies offering say-on-pay proposals, about 40 companies failed to receive majority support. Cincinnati Bell and Beazer, along with five other companies so far, have been sued by their shareholders in 2011 as a result of a ''failed'' say-on-pay vote.

The facts and circumstances in these cases follow a consistent pattern:

- The compensation committee establishes and approves a compensation program for executive officers and states in the proxy statement that the company follows a ''pay-for-performance'' philosophy.
- The company suffers financial losses and/or stock price declines.
- Executives are awarded substantial compensation, oftentimes based on performance against pre-established performance metrics that were unrelated to the company's stock price or earnings.
- The compensation committee recommends that the shareholders approve the compensation paid to the executive officers.
- The say-on-pay proposal fails to achieve majority support by shareholders.
- The board does not rescind the compensation paid to the officers.
- Plaintiff shareholders bring a derivative lawsuit on behalf of the company against the board of directors, executive officers, and sometimes third-party compensation consultants, asserting breach of fiduciary duty, unjust enrichment, and other related claims described below.
- Plaintiffs do not preface the lawsuit with a demand on the board to

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consider and evaluate the claims—on the theory that such demand would be futile.

Complaints filed in the say-on-pay lawsuits uniformly include some combination of the following allegations:

Against the board of directors:

- breach of fiduciary duties of loyalty, candor, and good faith;
- invalid exercise of business judgment;
- corporate waste; and/or
- false and misleading representation.

Against individual executive officers:

- unjust enrichment,
- aiding and abetting the directors' breaches of fiduciary duties, and/or
- false and misleading representation.

Against the board's compensation consultants:

- aiding and abetting the directors' breaches of fiduciary duties, and/or
- breach of contract to render competent and sound advice.

Parsing the Legal Theories

A corporate director stands in a fiduciary relationship with the corporation and, as such, owes certain duties to the corporation. A fiduciary duty claim brought against a director of a corporation is governed by the laws of the state of incorporation. Many corporations are incorporated in Delaware, which has a highly developed case law in matters of director duties and corporate governance. Decisions of the Delaware courts often serve as models for interpretation of other states' laws in this area.

Under long-standing principles of law, the ability to make compensation decisions has been uniquely housed with the board of directors and cloaked with the protection of the ''business judgment rule''—a judicially created rebuttable presumption that limits the ability to second-guess board decisions made honestly and in good faith. In connection with the *Disney* litigation last decade, the Delaware Supreme Court reiterated these two principles pointedly and succinctly: ''[A] board's decision on executive compensation is entitled to great deference. It is the essence of business judgment for a board to determine if a particular individual warrant[s] large amounts of money, whether in the form of current salary or severance provisions.'' *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000).

Under the business judgment rule as articulated in Delaware, directors' compensation decisions should be respected by courts unless the directors lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose, or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.

The say-on-pay lawsuits uniformly allege (i) that the business judgment rule was sufficiently rebutted by the fact that the company's say-on-pay proposal failed to attain majority shareholder support, and (ii) that pre-suit demand on the board to consider the claims was excused due to futility.

The short-comings identified in the 'Beazer' pleadings could provide a road map for more precise pleading in future cases.

The first two court decisions in the say-on-pay litigation yielded opposite results at the motion-to-dismiss stage, introducing nettling uncertainty about the significance and role of say-on-pay results going forward. Let's take a look.

'Beazer' in a Nutshell: Dismissed

The facts in *Beazer* followed the familiar pattern described above. Plaintiffs made the following allegations:

First, the directors were claimed to have breached their fiduciary duties of loyalty, candor, and good faith by approving ''excessive'' pay to officers and recommending the same for approval by the shareholders, in a year in which the company had suffered a net loss and declining stock price. Plaintiffs alleged that the directors' decision to increase pay in these circumstances was disloyal, unreasonable, and not the product of a valid exercise of business judgment and that the negative results of the say-on-pay vote *in and of itself* was sufficient to rebut the presumption of the business judgment rule. The plaintiffs further alleged that the board's say-on-pay recommendation was false and misleading in that it failed to disclose (i) that the pay was excessively large and irrational based on the company's negative 2010 results, and (ii) that the executive pay violated the company's stated pay-for-performance philosophy.

Second, the board's independent compensation consultants, PricewaterhouseCoopers and Markson, were alleged to have aided and abetted the directors' breaches of fiduciary duty and also to have directly breached their own contracts to provide competent and sound advice as compensation consultants.

Finally, the plaintiffs made claims of unjust enrichment against certain executive officers who received the pay approved by the board.

On Sept. 15, 2011, a Georgia court, applying Delaware law, dismissed the lawsuit against all defendants on the following bases:

1. First, the court concluded that the plaintiffs lacked standing to sue because they did not allege to be shareholders at the time the compensation decisions were made. The court ruled it insufficient for standing purposes to be a shareholder only as of the date of *payment* of compensation, where the incentive program under which the payment was earned was established and approved before the plaintiffs' stock ownership arose.
   - This is a factual malady that could easily be avoided by plaintiffs in future say-on-pay litigation.
2. More significantly, the court concluded that the plaintiffs failed to sufficiently allege excuse from the requirement of making a pre-suit demand on the board to evaluate the claims on behalf of the company. Such a pre-suit demand is a necessary condition of bringing a shareholder derivative lawsuit, unless the plaintiff can show that it would be futile.
   - Applying Delaware law, the court concluded that the plaintiffs failed to plead particularized facts raising a reasonable doubt either (i) that the board was disinterested (i.e., not motivated by self-dealing), or (ii) that the challenged decision was the result of a valid business judgment. Plaintiffs did not question the independence of board members, but rather focused on the rebuttal of the business judgment rule. Notably, the court rejected the premise that the mere fact of a

negative say-on-pay vote constitutes evidence that rebuts the business judgment rule with respect to compensation decisions previously made (pointing out, logically, that the board could hardly have considered the results of the vote before it occurred). ''Hindsight second-guessing and Monday morning quarterbacking of the sort Plaintiffs urge are fundamentally inconsistent with the business judgment analysis'' said the *Beazer* court.

- In support of its dismissal, the court also cited the Dodd-Frank Act provisions (quoted above in this article) expressly preserving the pre-existing fiduciary duty framework concerning directors' executive compensation decisions, thereby rejecting the notion that a failed say-on-pay vote has any independent probative significance.
- For related reasons, the court also rejected plaintiffs' demand futility allegation as to their other claims.

3. Finally, the court dismissed the lawsuit on the basis that the plaintiffs failed to state a claim on which relief could be granted.

- Due to the failure to allege facts sufficient to rebut the business judgment rule, the court ruled that the plaintiffs failed to state a claim for breach of fiduciary duties.
- Similarly, because the court concluded that no facts were pleaded in support of the allegations of (i) false and misleading statements in the proxy statement, (ii) aiding and abetting or breach of contract by the consultants, or (iii) unjust enrichment of the officers, the case was dismissed for failure to state a claim on those grounds as well.

'Cincinnati Bell' Survives Round One

Again, in *Cincinnati Bell* we start with the familiar say-on-pay lawsuit fact pattern outlined at the beginning of this article (substantial executive pay awarded in a year in which the company exhibited dismal financial performance, followed by a negative say-on-pay vote). Similar to *Beazer*, the plaintiff alleged (i) breach of fiduciary duties of loyalty, candor, and good faith by the board, (ii) aiding and abetting by the compensation consultant, and (iii) unjust enrichment of the named executive officers.

On Sept. 20, 2011, a federal court in Ohio, applying Ohio law, *denied* the defendants' motion to dismiss the say-on-pay lawsuit on the following bases:

1. First, the court ruled that factual allegations in the complaint raised a ''plausible claim'' that pay raises and bonuses approved by the board at a time of declining financial performance violated a pay-for-performance policy and were not in the best interests of shareholders and, therefore, constituted an abuse of discretion and/or bad faith.

- In so holding, the *Cincinnati Bell* court had a different take than the *Beazer* court as to the sufficiency of the pleadings, although the complaints in each case contained similar factual allegations. Both cited the leading 2007 U.S. Supreme Court case, *Bell Atlantic v Twombly*, which heightened the pleading requirement for federal civil cases, requiring that plaintiffs include enough facts in the complaint to make it plausible—not merely conceivable—that they will be able to prove facts to support their claims. Only the *Cincinnati Bell* court, however, was willing to accept the ''fact'' of a negative say-on-pay vote as sufficient evidence, at the pleadings stage, to rebut the business judgment rule and introduce a plausible argument for liability.
- Moreover, the *Cincinnati Bell* court cites Ohio law stating that it is not necessary to plead ''operative facts'' in a complaint to rebut the business judgment rule. (It also cites pre-*Twombly* federal law for the same proposition, with no attempt to reconcile the subsequent, more narrow, ruling in *Twombly*.) Delaware law, as applied in *Beazer*, appears to present a higher bar for rebuttal at the pleadings stage.

2. Equally important, the *Cincinnati Bell* court ruled that the plaintiff was excused from pre-suit demand due to futility.

- The court concluded that the facts that (i) the board devised, approved, and recommended the challenged pay; and (ii) suffered a negative say-on-pay vote demonstrated sufficient facts to give reason to doubt that the directors could make unbiased, independent business judgment as to whether to sue themselves for breach of fiduciary duty. At the dismissal stage, this was deemed sufficient to create a reasonable doubt as to the availability of the business judgment rule and, accordingly, to render pre-suit demand unnecessary.

3. Finally, the court concluded that the claim for unjust enrichment was sufficient under Ohio law.

- Here the court was somewhat circular in its conclusion, stating that because the plaintiff sufficiently pleaded facts of breach of fiduciary duty by the directors, it was ''axiomatic'' that the plaintiff also sufficiently pleaded a claim for unjust enrichment by the executives.

What Observations Can Be Drawn?

1. Different state laws were being applied in these two cases (Ohio vs. Delaware), which could account for the opposite results on very similar allegations. Notably, although six of the nine companies that have had say-on-pay lawsuits are Delaware companies, none of the lawsuits was filed in Delaware courts. Perhaps the plaintiffs' counsel preferred to avoid having their novel say-on-pay legal theories vetted by seasoned Delaware courts applying well-established Delaware fiduciary duty legal principles.

2. It is noteworthy that all of the say-on-pay lawsuits allege breaches of the fiduciary duties of loyalty and good faith (rather than the duty of care). Almost all companies have taken advantage of state laws shielding directors from monetary damages for breach of fiduciary duty, except in the case of disloyalty, bad faith, intentional malfeasance, or improper personal gain. In short, there is ''no money'' in suing directors unless one can prove disloyalty or bad faith. Moreover, a director found liable for disloyalty or bad faith would not be entitled to indemnification and would likely be uninsurable—another reason why the stakes are so high for directors in these say-on-pay lawsuits.

3. The short-comings in the pleadings identified in *Beazer*, which led to the dismissal, could provide a road map for more precise pleading in future cases. In any event, the *Cincinnati Bell* decision is likely to encourage more say-on-pay lawsuits, if for no other reason than surviving a motion to dismiss creates leverage for more lucrative settlements.

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