Harvard Law School Forum on
Corporate Governance and Financial Regulation

Say-on-Pay and the Business Judgment Rule

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Tags: **Beazer v. McCarthy**, **Business judgment rule**, **Cincinnati Bell v. Cox**, **Dodd-Frank Act**, **Executive Compensation**, **Say on pay**
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Editor's Note: **Edward Greene** is a partner at Cleary Gottlieb Steen & Hamilton LLP focusing on corporate law matters. This post is based on a Cleary Gottlieb Alert Memorandum; the full version of the memo, including omitted footnotes, is available **here**.

Over 40 companies received negative say-on-pay advisory votes in 2011, the first year for those votes under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act"). Despite the advisory nature of the votes and the Act's helpful language that they are not intended to affect director fiduciary duties, at least ten derivative lawsuits have been filed after failed votes. Two present an interesting contrast insofar as they address the "business judgment rule" and the requirement of pre-suit demand in the context of executive compensation. The first involves Cincinnati Bell and was brought in federal court in Ohio under Ohio law. It is the only such suit to survive a motion to dismiss to date. The other is a case involving Beazer Homes, which was dismissed by a Georgia state court applying Delaware law. We believe that the *Cincinnati Bell* case is inconsistent with the historical application of the business judgment rule and that *Beazer Homes* will ultimately prove the majority approach. Nonetheless, the cases bear consideration for what they suggest about the importance of process in making compensation decisions.

The Citadel of Business Judgment?

The new say-on-pay derivative suits come in the context of a decade-long reevaluation, in the Delaware courts and elsewhere, of the fiduciary duties of directors and executives in the compensation context. Traditionally, the courts interpreted the so-called "business judgment rule" as an almost unassailable citadel of discretion for directors determining management pay. Under the rule, "informed decisions regarding employee compensation by independent boards" are shielded from judicial review unless plaintiffs can overcome a presumption that directors acted on an informed basis, in good faith, and in the honest belief that those decisions were in the best interests of the company." Unless shareholders allege particular facts calling these elements into question, the presumption stands and a motion to dismiss for failure to state a claim is granted. If the presumption is defeated, defendants must prove the "entire fairness" of a transaction – both that it was arrived at through a process of fair dealing and that it was substantively fair.

Even as litigation involving corporate governance matters has increased, Delaware courts have repeatedly affirmed the continuing vigor of the business judgment rule. But it is clear that courts will carefully scrutinize the factual allegations to determine the appropriateness of its application in a given context. In the case of executive compensation, several cases in recent years have suggested a greater willingness of the courts to find that plaintiffs have overcome the presumption.

Most often, the allegations in these cases have involved facts suggesting that directors were not sufficiently independent. Independence is a deal-specific inquiry under Delaware state law, separate from similar requirements under stock exchange listing rules, securities law and the tax code. For example, when Disney shareholders challenged the severance package paid to outgoing president Michael Ovitz, the Chancery Court found that a reasonable doubt had been raised about the independence of one purportedly independent director (although not others) who had approved the compensation. Similarly, a suit by shareholders of ICN Pharmaceuticals went to trial on allegations that the process for awarding bonuses was compromised by management domination and the advice of conflicted compensation consultants.

In other cases, even when directors were found to be independent, courts have concluded that plaintiffs pled facts suggesting that the board failed to act in an informed and faithful manner. In a suit against directors of Integrated Health Services, for example, shareholders alleged that the compensation committee and the full board approved, and later forgave, loans to the CEO without any deliberation or consideration. The court found that these allegations, if true, implied that the board "consciously and intentionally disregarded [its] responsibilities."

Cincinnati Bell* and *Beazer Homes

In May 2011, Cincinnati Bell shareholders voted against approval of the company's 2010 executive compensation. Following the vote, the NECA-IBEW Pension Fund brought a derivative suit against the board of directors in the United States District Court for the Southern District of Ohio. The plaintiff alleged that directors had breached their fiduciary duty of loyalty when they approved salary increases and bonuses for Cincinnati Bell's CEO and other top executives. To support this allegation, the plaintiff made two factual claims: first, that the bonuses, which totaled over $4 million for the top five executives, and salary increases awarded were inconsistent with the company's performance, as measured by net income, earnings per share, share price and annual shareholder return; and second, that the negative say-on-pay vote provided "direct and probative evidence that the 2010 executive compensation was not in the best interests of the Cincinnati Bell shareholders." The directors moved to dismiss the suit, arguing that the facts alleged were insufficient to overcome the presumption of the business judgment rule. Under Ohio law, the presumption applies unless directors are shown to have acted with "a deliberate intent to cause injury to the corporation" or "reckless disregard for the best interests of the corporation."

The court denied the motion to dismiss. Stating that the business judgment rule "imposes a burden of proof, not a burden of pleading," the court accepted that plaintiff's factual allegations were sufficient for the case to proceed. Specifically, it stated "[t]hese factual allegations raise a plausible claim that the multi-million dollar bonuses approved by the directors in a time of the company's declining financial performance violated Cincinnati Bell's pay-for-performance compensation policy and were not in the best interests of Cincinnati Bell's shareholders and therefore constituted an abuse of discretion and/or bad faith." This finding is particularly notable – and troubling. By reaching this conclusion without any facts suggestive of abuse of discretion or bad faith having been pled, the court seemed prepared to engage in the kind of second-guessing that the business judgment rule is intended to foreclose.

The *Cincinnati Bell* court also concluded that pre-suit demand on the board was excused as futile. The court argued that the directors who devised and approved the compensation package, and whose recommendation to approve the package failed, were unable to make "unbiased, independent business judgments about whether to sue" on behalf of the company. The court reached this conclusion despite the fact that all of the company's directors were independent, other than the CEO. This reasoning is also troubling. The requirement of pre-suit demand would have little import if mere involvement as a director in a board-level matter disqualifies directors from evaluating a derivative claim.

Cincinnati Bell stands in stark contrast to *Beazer Homes* on both procedural and substantive grounds. The *Beazer Homes* court granted defendants' motion to dismiss on multiple grounds, but in particular found that pre-suit demand was not excused. Like the board in *Cincinnati Bell*, only one Beazer director (the CEO) received the compensation at issue, and there were no allegations that the challenged compensation "was not in fact awarded consistent with executives' performance against [. . .] predetermined financial and non-financial goals and targets," that the Beazer board failed to act in good faith, or that directors did not "believe that those performance goals and targets were critical to enhancing stockholder value, and, thus, appropriate metrics upon which to base executives' compensation."

The *Beazer Homes* court also rejected the contention that the failed say-on-pay vote rebutted the presumption of the business judgment rule. Since the pay decisions preceded the vote, the outcome of the vote could not be evidence that directors had not acted properly: "[h]indsight second-guessing and Monday morning quarterbacking of the sort Plaintiffs urge are fundamentally inconsistent with the business judgment analysis." In reaching its decision, the court nevertheless suggested that an adverse vote, together with other evidence, could rebut the presumption: "[t]his Court will not conclude that an adverse say on pay vote alone suffices to rebut the presumption of business judgment protection."

Takeaways

We believe that the court in *Cincinnati Bell* went too far, and we expect that the logic of the *Beazer Homes* court will ultimately prevail in these new say-on-pay suits. The facts in *Cincinnati Bell* are not remarkable: the directors awarded compensation based on satisfactory performance under pre-arranged metrics, and shareholders disappointed by poor performance on other measures returned a negative say-on-pay vote. If these facts alone are sufficient to survive a motion to dismiss, it would constitute a shocking and harmful exception to the business judgment rule.

Pending the outcome in other say-on-pay cases, *Cincinnati Bell* increases the risk associated with executive compensation decisions. The case underscores the importance of a thoughtful, well-documented compensation-setting process. While judicial action will remain unpredictable in the short term, companies with careful practices should face lower risks in the courtroom. Companies and their compensation committees should therefore:

- Carefully consider the independence of directors, particularly compensation committee members. Among other steps, companies should seek to ensure proper attention by directors to their responses to director and officer questionnaires.
- Scrupulously document compensation decision-making processes in pre-read materials and board and committee minutes, so as to demonstrate that directors were informed and engaged in a good faith evaluation of pay decisions and made them in the best interests of shareholders and the company.
- Pay special attention to the rationale for compensation decisions where the company has underperformed its designated peers or the industry, even as executive compensation has increased. Even if not required as part of determining performance under the company's executive compensation plans, the compensation committee should review the company's one-, three- and five-year performance and total compensation relative to these groups. The committee should likewise be informed about components of the company's compensation programs and or recommendations about pay decisions that may not conform to current trends in executive compensation, even where the deviations may be justified. In each of these cases, compensation disclosures should clearly and cogently set out the rationale for the committee's determinations, and management should consider with the committee whether additional engagement with both proxy advisory services and shareholders before the annual meeting is appropriate.
- Consider carefully how they formulate their executive compensation objectives and related CD&A disclosures. In today's environment, "pay-for-performance" has become something of a slogan, and broad policy assertions may not be appropriate without more nuanced explanations of how the policy is expected to be applied in both good and bad times.
- Avoid unnecessarily attracting the attention of opportunistic potential plaintiffs by adopting "best practices" to the extent practical, including for example the use of fully independent compensation consultants who report exclusively to the compensation committee and whose interactions with management are subject to committee oversight.
- Prepare appropriate responsive action, either through changes in pay practices or renewed shareholder engagement, in the event of a say-on-pay vote that is either negative or indicates significant dissent. As required, these actions should be disclosed, together with the rationale accompanying changes in pay practices as part of the next year's CD&A.