SAY WHAT!? RESULTS OF THE FIRST YEAR OF MANDATORY SAY ON PAY IN THE UNITED STATES AND RELATED LITIGATION

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INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or the "Act") was arguably the broadest, most comprehensive financial regulatory reform legislation to be passed by Congress in decades, comprising some sixteen titles, hundreds of new statutes and many hundreds of pages of new law.[1] Securities and Exchange Commission ("SEC") Chair Mary Schapiro calls it "landmark legislation" intended "to reshape the U.S. regulatory landscape, reduce systemic risk, and help restore confidence in the financial system."[2] Enacted in the wake of a severe economic crisis resulting in part from excessive risk taking involving securitized real estate mortgages by various large financial institutions, the Act addresses mortgage lending abuses, financial stability issues, complex derivative securities, and certain other issues thought to be germane to the cause of the crisis. But the Act reaches far beyond remedying these issues to also regulate a number of other areas on the wish list of various special interest groups.

One of the items captured by the multi-tentacle reach of the Dodd-Frank Act is executive compensation at public companies.[3] While the limits of executive compensation are drawn by duties of loyalty and due care im-

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* Member, Dykema Gossett PLLC. The author gratefully acknowledges the assistance of John J. Collins III of Dykema Gossett PLLC in the preparation of this article.

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat 1376 (20120).

2. *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act,* SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/spotlight/dodd-frank.shtml (last visited Mar. 30, 2012).

3. *See, e.g.,* 15 U.S.C.A. § 78n-1 (West 2010) (say on pay); 15 U.S.C.A. § 78j-3 (West 2010) (compensation committee authority and independence and consultant independence); 15 U.S.C.A. § 78n (West 2010) (disclosure regarding pay for performance and internal pay ratio); 15 U.S.C.A. § 78j-4 (West 2010) (compensation clawback).

posed by state law on directors elected by shareholders to oversee the management of the company, Congress availed itself of the opportunity afforded by the financial crisis to appease various constituencies by attempting to influence executive compensation levels. One means of influencing compensation was to direct the SEC to adopt additional disclosure requirements that forces public companies to disclose information regarding the relationship between executive compensation and company performance and to disclose the relationship between compensation paid to the chief executive officer and the median pay to all employees of the company.[4] In the same vein, to allow shareholders to express their discontent with the lucrative compensation paid to many public company executives and to pressure the board of directors[5] to put tighter controls on executive compensation, the Act also imposed a requirement on virtually all companies that are publicly traded in the United States[6] to hold an "advisory" shareholder vote on the company's executive compensation as disclosed in its annual meeting proxy statement at least once every three years.[7]

The requirement for a so-called "say on pay" or "SOP" vote is an idea borrowed in part from Section 111 of the Emergency Economic Stabilization Act of 2008,[8]which requires such a vote annually at each company that received funding from the U. S. Treasury under its Capital Purchase Program, and say on pay requirements were previously adopted voluntarily by some U. S. public companies in response to pressure from shareholder activists and others.[9] The requirement for such a vote was a somewhat con-

4. Congress took a more direct approach with executive compensation of financial institutions in Section 956 of the Act by requiring all federally regulated financial institutions with assets of more than $1 billion to report their compensation to their regulators, and prohibiting compensation that provides an executive officer, employee, director, or principal shareholder of the covered financial institution with "excessive compensation, fees, or benefits," or that could lead to material financial loss to the covered financial institution. 12 U.S.C.A. § 5641 (West 2010).

5. Compensation decisions at most public companies are made by the outside independent directors or a committee comprised of outside independent directors in compliance with applicable stock exchange requirements. References throughout this article to the board of directors are intended to include these compensation committees.

6. *See* 15 U.S.C. § 78 (2012). The requirement applies to all companies registered under the Securities Exchange Act of 1934 (the "Exchange Act"), as amended other than smaller reporting companies as defined in Exchange Act Rule 12b-2. Smaller reporting companies will become subject to the requirement in 2013.

7. The frequency of the vote is determined by the board following an advisory vote on the matter by shareholders held every six years. *See* Section 951 of the Dodd-Frank Act, 15 U.S.C. § 78n-1 (2012).

8. Emergency Economic Stabilization Act of 2008, Pub. L. 110-343, 122 Stat 3765 (2008).

9. In the United Kingdom, the Companies Act 2006 requires public companies to prepare a remuneration report and submit it to an advisory vote of shareholders. Companies Act 2006, 2006, c. 46, §§ 420-22, 439 (U.K.).

troversial addition to the Dodd-Frank Act.[10] Although many believed that media coverage of multi-million dollar compensation for some executives would result in a widespread showing of shareholder dissatisfaction with executive compensation practices, thus pressuring boards of directors to reduce executive compensation levels,[11] the results of the voting showed quite the opposite. More than 98% of companies in the Russell 3000[12] that held say on pay votes in 2011 received a favorable vote on their SOP proposal, with an average vote of more than 92% of the votes cast in favor of the proposal.[13] These results indicate that last year, the answer for most public companies to whether shareholders approved of compensation practices at the companies in which they had invested was a resounding "yes," though only time will reveal whether that answer was attributable to true satisfaction, favorable shareholder returns in the prior year, inattention by shareholders, or some other factor or combination of factors.

This article examines several aspects of the results of the first year of mandatory say on pay in the United States. Part II contains a brief discussion of various ways in which shareholders could and, in some cases, did react to a negative say on pay vote at the relatively few companies whose SOP proposals did not pass. Part III reviews the litigation based upon negative say on pay votes, summarizing the common allegations and primary claims made, as well as the defenses raised in light of language in the Dodd-Frank Act, applicable state statutory and common law and the "business judgment rule." Recognizing the importance of obtaining a positive SOP vote in light of the increased risk posed by the litigation, Section IV reviews various lessons learned from the first year of mandatory say on pay, as well as ways to increase the probability of obtaining a positive SOP vote and strengthen a company's defenses in the event of SOP-based litigation.

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10. *See, e.g.*, Michael Corkery, *SEC Commissioner Paredes Slams Dodd Financial Reg. Bill*, WALL ST. J. BLOGS, (Apr. 15, 2010, 4:44 PM), http://blogs.wsj.com/deals/2010/04/15/sec-commissioner-paredes-slams-dodd-financial-reg-bill; S. REP. NO. 111-176, at 115 (2010).

11. *See, e.g.*, Jessica Holzer, *SEC, in Split Vote, Adopts 'Say on Pay' Rule*, WALL ST. J., Jan. 26, 2011, at C3; Erin White, *Occidental Petroleum Investors Balk at Executive-Pay Practices*, WALL ST. J., May 8, 2010, at B6.

12. Russell 3000 Index, RUSSELL INVESTMENTS, http://www.russell.com/indexes/data/fact_sheets/us/russell_3000_index.asp (last visited Mar. 24, 2012). According to the Russell Investments website, the Russell 3000 is an index comprising the largest 3000 publicly traded companies in the United States, and representing approximately 98% of the investable United States equity market. *Id*.

13. TED ALLEN ET AL., INSTITUTIONAL SHAREHOLDER SERVICES INC., 2011 U.S. POST SEASON REPORT 4, 7 (2011) [hereinafter ISS REPORT]. Other statistical analyses of the voting results by industry group, size of company, and other categories are widely available on the Internet.

I. SHAREHOLDER REACTION

Although more than 98% of Russell 3000 companies received an overwhelmingly positive SOP vote, there were 40 or so[14] companies whose SOP proposal was defeated in the 2011 proxy season for which the news was not as good. These companies, as well as those companies whose SOP proposal carried by only a narrow margin,[15] have a higher risk of a negative shareholder reaction to their compensation practices in 2012; although fear of shareholder dissension in connection with the new SOP requirement has had the effect of requiring all public companies to be more vigilant in structuring and overseeing their compensation practices.[16] These at-risk companies could see shareholders and proxy advisors express their dissatisfaction in a variety of ways, such as:

1. A negative vote recommendation by proxy advisors such as Institutional Shareholder Services ("ISS") regarding the election of the relevant directors;[17]
2. A campaign by activist shareholders to withhold votes from directors;[18]
3. A sell-off by shareholders disillusioned by an unresponsive board, which could result in a decline in the stock price; or
4. A proxy contest to replace part or all of the board.[19]

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14. *Id*. at 7. The ISS Report collected data as of September 1, 2011. Several more companies have since reported negative SOP votes.

15. Roughly 8% of the Russell 3000 received less than 70% support of their SOP proposal, according to a Semler Brossy Consulting Group report. *See* Semler Brossy Consulting Grp., *2011 SAY ON PAY RESULTS: RUSSEL 3000* 10 (Aug. 26, 2011), *available at* http://www.semlerbrossy.com/wp-content/uploads/2012/04/SBCG-SOP-2012-04-11.pdf.

16. Russell Miller & Yonat Assayag, *SOP Drives Compensation Program Changes to Enhance Pay/Performance Link*, THE CONFERENCE BOARD, Sept. 2011, at 1, 1-3, *available at* http://clearbridgecomp.com/wp-content/uploads/TCB_DN-V3N18-11.pdf.

17. INSTITUTIONAL SHAREHOLDER SERVICES INC., U.S. CORPORATE GOVERNANCE POLICY 2012 UPDATES 8 (2011) [hereinafter ISS 2012 UPDATES].

18. The effect of such a campaign will depend upon whether the vote required for election is a plurality or majority. A withhold vote in a plurality vote setting is largely symbolic and is highly unlikely to affect the outcome of the election, but will send a message to directors and may be embarrassing to the company. In a majority vote setting, a campaign for votes against could result in the director being required to tender his or her resignation. Failure by the board to accept the resignation may result in further problems for the board based on a perceived lack of responsiveness to shareholders.

19. Proxy contests may become more commonplace in view of the SEC's recent change to Rule 14a-8 permitting shareholders to propose, in management's proxy statement, so called "proxy access" bylaw amendments that would, in turn, permit shareholders to include, in management's proxy statement, director candidates not nominated by the board, greatly reducing the cost to shareholders of nominating competing candidates. John D. Tishler & Louis Lehot, *Amendments to SEC Rule 14a-8 Allowing Shareholder Proposals for Proxy Access Regimes to Come into Effect*, THE NATIONAL LAW REVIEW (Sept. 13, 2011),

Another way in which shareholders have expressed dissatisfaction with compensation practices has been through litigation. The practice of bringing derivative litigation against the directors of companies to challenge compensation decisions is not new.[20] However, the onset of SOP voting has led to a spate of such cases in the past eighteen months, as several of the companies whose SOP proposals were defeated in 2011[21] and three additional companies whose proposals were defeated in 2010[22] have been sued in putative shareholder class action suits seeking relief from the board, the officers, and the compensation consultant retained by the compensation committee of the board. The suits involving failed SOP proposals typically seek damages on behalf of the company, disgorgement from the officers of "excess" compensation, and other equitable relief, along with changes in internal controls to prevent "excessive compensation" from being paid in the future.[23]

The SOP-based litigation is primarily based on a derivative claim against the directors for breaching their fiduciary duty by approving total executive compensation that increased during a year in which there was a decline in the market price per share for the company's common stock and/or earnings compared to the prior year. The complaints also have typically included ancillary claims against the board's compensation consultant for aiding and abetting the alleged breach and for breaching its contract with the company,[24] and against the company's executives (and sometimes its directors)

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http://www.natlawreview.com/article/amendments-to-sec-rule-14a-8-allowing-shareholder-proposals-proxy-access-regimes-to-come-eff.

20. One famous instance of this type of litigation in recent years was the long court battle involving the compensation package provided to the potential successor of Disney's Chief Executive Officer, Michael Eisner. *See* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

21. *See, e.g.*, Complaint, Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy, No. 2011-CV-197841, 2011 WL 901905 (Ga. Super. Ct., Mar. 15, 2011) [hereinafter Beazer Homes Complaint]; Complaint, NECA-IBEW Pension Fund v. Cox, No. 1:11-CV-451, 2011 WL 4383368 (S.D. Ohio, Sept. 20, 2011) [hereinafter Cincinnati Bell Complaint]; Complaint, Haberland v. Bulkeley, No. 5:11-CV-00463-D (E.D.N.C., Sept. 1, 2011); Complaint, Pinsly v. Scheid, No. 1:11-CV-01732-WYD-BNB (D. Colo., July 1, 2011) [hereinafter Janus Capital Complaint]; Complaint, Witmer v. Martin, No. BC454543, 2011 WL 3922597 (Cal. Super. Ct., Feb. 4, 2011); Complaint, Matthews v. Rynd, No. 2011-34508 (Tex. Dist., June 8, 2011); Complaint, Plumbers Local No. 137 Pension Fund v. Davis, No. 3:11-CV-00633-AC (D. Or., May 25, 2011) [hereinafter Umpqua Holdings Complaint]; Complaint, City of Sterling Heights Police & Fire Ret. Sys. v. Kratz, No. 4:2011-CV-02537 (S.D. Tex., July 8, 2011)

22. Complaint, Gusinsky v. Irani, No. BC442658 (Cal. Super. Ct. July 29, 2010) [hereinafter Occidental Petroleum Complaint]; Complaint, King v. Meyer, No. 1:10-cv- CV-10-730994-DAP (Ohio Ct. Com. Pl. July 6, 2010) [hereinafter Keycorp Complaint]; Dennis v. Hart, No. 3:2011-CV-02271, 2011 WL 7564100 (S. D. Cal. Sept. 30, 2011) [hereinafter PICO Holdings, Inc].

23. *See, e.g.*, Beazer Homes Complaint, *supra* note 21, at *17.

24. *Id*. at *16.

for unjust enrichment arising out of the compensation purportedly paid in breach of the board's fiduciary duties.[25] While these claims seem frivolous on their face in light of decades of corporate jurisprudence, the existence of the litigation is potentially embarrassing to these companies, costly, distracting, and time-consuming to defend, and increases the risk of personal liability for the director defendants. One court has even refused to grant a motion to dismiss one of the SOP-related complaints.[26] As a result, the merits of the breach of fiduciary duty claims bear closer scrutiny.

II. THE SOP LITIGATION

The structure and allegations in the complaints are very similar.[27] At their core, the complaints allege essentially the following:[28]

1. The company's proxy statement states that the company's executive compensation policy is firmly rooted in a pay-for-performance philosophy, quoting language from the Compensation Discussion and Analysis ("CD&A") section of the company's most recent annual meeting proxy statement and occasionally language from prior proxy statements;[29]

2. The company's performance, measured by plaintiffs primarily based on the company's total shareholder return during the year (stock price change plus dividends) and occasionally earnings, earnings per share and/or shareholders' equity, was negative during the most recent year;[30]

25. *Id*. at *17; *see also* Keycorp Complaint, *supra* note 22, at *33.

26. The Federal District Court for the Southern District of Ohio in Cincinnati Bell, discussed in more detail below. *See infra* text accompanying notes 61-65.

27. One of two plaintiffs' law firms have been involved in virtually all of the SOP-based litigation as lead or co-counsel.

28. The list below is intended to summarize the allegations made across all of the cited complaints, but not every complaint contained each of the allegations listed below. *See infra* part III. The Beazer Homes Complaint is illustrative of most of these allegations. *See generally* Beazer Homes Complaint, *supra* note 21. Also, the complaints include allegations to support the plaintiffs' claim that demand would have been futile and, therefore, should be excused. Since the related pleading requirements vary from state to state and much of the analysis of the business judgment rule on this point applies equally to the substantive claims discussed below, demand futility is not addressed separately in this article.

29. *See, e.g*., Beazer Homes Complaint, *supra* note 21, at *7-8.

30. *Id.* at *8.

3. The executive compensation approved by the board increased during the most recent year, as measured by the total compensation shown in the Summary Compensation Table of the company's most recent annual meeting proxy statement;[31]

4. Since "compensation" increased while "performance" decreased during the year, the pay increases violated the company's pay-for-performance policy; [32]

5. As required by the Dodd-Frank Act and related SEC rules, the company's most recent annual meeting proxy statement included a say on pay proposal, which the board recommended that shareholders approve;[33]

6. Despite the board's recommendation, shareholders voted against the SOP proposal by at least a majority of the shares voted on the proposal;[34]

7. The negative SOP vote rebuts the presumption of the business judgment rule that the board's approval of the compensation increases for the year was in the best interests of the shareholders;[35]

8. The board breached its duty of loyalty by granting the executive pay increases in violation of its pay-for-performance policy and failing to rescind or "claw back" the "excessive" compensation after the negative SOP vote,[36] thereby putting the interests of the executives ahead

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31. *Id.* The total includes estimated values, based on various assumptions, for items of compensation that may only be recognized in the future or never, such as stock and option awards that vest in the future only if the recipient remains employed and, in the case of options, only if the company's stock price increases; cash or equity awards that will be earned only if company performance-based conditions are satisfied; and the change in pension value and deferred compensation.

32. *Id*. at *13.

33. *Id*. at *9-11.

34. *Id*. at *11.

35. Beazer Homes Complaint, *supra* note 21, at *11-13.

36. *Id*. at *12. None of the complaints address how a clawback would have been accomplished or how much of the compensation was excessive. Once compensation is granted, whether cash-based or equity-based, executives typically have a contractual right to the compensation if the conditions of the grant are satisfied, and the company usually has no contractual right to claw back the compensation once the relevant conditions are met in the absence of fraud or mistake in connection with the preparation of the financial statements on

of the company. Some plaintiffs also made allegations that the outside directors acted in their own interests in making the executive compensation decisions, but generally did not allege any specific facts in this regard;[37]

9. Payment of the "excessive" compensation was a diversion of corporate assets that breached the directors' duty of loyalty. In some cases, the plaintiff made a separate claim of corporate waste based on the same allegations;[38]

10. The board breached its duty of candor by failing to state in the proxy statement that the compensation was excessive or irrational and that the compensation increase violated the pay-for-performance policy, which were material facts necessary for shareholders to make an informed decision;[39]

11. The board's recommendation to shareholders to approve the SOP proposal was false and misleading, and stating that executive compensation during the year was paid in accordance with the pay-for-performance policy was a material misrepresentation. Therefore, the directors breached their duty of candor;[40]

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which the compensation was based. A demand by the company that executives pay back compensation otherwise earned during the year, notwithstanding the applicable contractual provisions, would likely create morale and retention issues absent a financial crisis at the company threatening its ability to continue to do business.

37. *Id*. at *13. The Occidental Petroleum Complaint alleged that the outside directors benefited from their executive compensation decisions because they received their directors fees, which were higher than the fees other companies pay. *See generally* Occidental Petroleum Complaint, *supra* note 22. The complaint does not indicate how the executive compensation decisions affected the amount of the director compensation or otherwise benefited the directors, however, and fails to acknowledge that the board, not management, determines director compensation. *Id*. The Janus Capital Complaint alleged that the board's actions allowed the directors to maintain their positions as directors, but fails to acknowledge that the board rather than management makes board nominations. *See generally* Janus Capital Complaint, *supra* note 21. Moreover, removal of a director during the director's term would require shareholder approval and excessive executive compensation that raises shareholders' ire would make removal *more* likely. *Id*. As a result, it is unclear how the directors' self interest could have been advanced by executive compensation decisions that increased pay.

38. *See, e.g*., Beazer Homes Complaint, *supra* note 21, at *15.

39. *Id*.

40. *Id*. at *13. Even assuming the proxy statement was required to include such information, it would appear that there was no harm done, as the vote was only an advisory vote and the result of the vote was against the SOP proposal despite the absence of this information. *Id*.

12. The board's misconduct was due to bad faith and was intentional or reckless;[41]

13. The directors acted irrationally and in reckless disregard of their fiduciary duties of loyalty, candor, and good faith.[42]

Under the corporate law of most states, directors owe fiduciary duties of due care and loyalty to the shareholders and companies they serve.[43] Executive compensation decisions are uniquely and properly within the authority and purview of a company's board of directors, or a committee thereof,[44] and, like most other actions taken by the board or a committee of the board, are protected by the business judgment rule. The business judgment rule is a legal presumption that, in taking an action, the board acted in good faith, on an informed basis and in the honest belief that the action was in the best interest of the company.[45] To overcome this presumption, the plaintiff must prove (i) the directors acted in bad faith;[46] (ii) the directors breached their duty of loyalty; (iii) the directors failed to exercise due care; or (iv) the action was a waste of corporate assets.[47] If the presumption is not overcome, the court will defer to the board's decision even if, in hindsight, it appears to have been wrong.[48]

Congress intentionally preserved this legal construct in the say on pay provision of the Dodd-Frank Act.[49] Referring to the SOP vote, subsection (c) of that provision states:

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41. *Id*. at *15.

42. *Id*. at *15-16.

43. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989). As part of the duty of loyalty, directors also have an obligation to act in good faith. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). The Michigan Business Corporation Act provides that a director of a Michigan corporation must discharge his or her duties as such in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner he or she reasonably believes to be in the best interests of the corporation. Michigan Business Corporation Act, MICH. COMP. LAWS § 450.1541(a) (2012). Under Delaware law, the so-called "duty of candor" is not a separate duty, but is derived from the duties of care, loyalty and good faith. Malone v. Brincat, 722 A.2d 5, 11 (Del. 1998).

44. See *In re* Walt Disney Co. Deriv. Litigation, 906 A.2d 27, 54 (Del. 2006); 8 Del. C. 141(a) (2012); 8 Del. C. 122(5) (2012); *see also* M.C.L. 450.1501 (2012); M.C.L. 450.1261(e) (2012).

45. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). See also Gray v. Zondervan Corp., 712 F. Supp. 1275 (W.D. Mich. 1988) and cases cited therein.

46. Bad faith means either (a) actual intent to do harm to the corporation or violate the law, (b) intentional dereliction of duty, or (c) a conscious disregard for one's responsibilities. *In re* Walt Disney, 906 A.2d at 67 (discussing bad faith at length).

47. *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000).

48. *Id.*; Aronson, 473 A.2d at 812.

49. 15 U.S.C.A. § 78n-1 (West 2010).

> Rule of Construction- The shareholder vote referred to in subsections (a) and (b) 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 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[.]

This language makes clear that Congress did not intend for the nonbinding SOP vote requirement to change the application of the business judgment rule, create any new fiduciary duties, overrule compensation decisions made by the board, or do more than act as a means for shareholders to inform the board of their collective view of the board's past compensation decisions.

Complicating matters further for the would-be plaintiff is the fact that most public companies have charter provisions eliminating the monetary liability of directors to shareholders for breach of fiduciary duty other than: (i) for any breach of the director's duty of loyalty; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) for improper dividends or other shareholder distributions; or (iv) for any transaction from which the director derived an improper personal benefit.[50]

Thus, for a shareholder to recover monetary damages against directors for a breach of fiduciary duty arising out of actions taken with regard to executive compensation, the shareholder must prove that the directors acted in bad faith or otherwise breached their duty of loyalty, *i.e.* by self-dealing or improper personal benefit. This is a high hurdle to overcome, particularly when a majority of the board consists of independent, outside directors who have no personal interest in the amount of compensation paid to executives. While the SOP litigation complaints make conclusory allegations of a breach of the duty of loyalty and of bad faith, or intentional misconduct, the most novel issue presented by most of these complaints is the argument that the negative SOP vote itself rebuts the presumption of the business judgment rule that the board's approval of the compensation for the year was in the best interests of the shareholders.[51] The argument is that because a ma-

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50. DEL. CODE. ANN. tit. 8, § 102(b)(7) (West 2011). Many states, including Michigan, have a similar enabling statute. *See* MICH. COMP. LAWS ANN. § 450.1209(c) (West 2012).

51. If the plaintiff is successful in proving a breach of duty of loyalty or bad faith so that the burden of proof is shifted to the defendant directors and the directors are not able to prove that their actions or determinations were entirely fair to the company and its shareholders, then the directors would likely not be protected by the charter limitation on monetary liability since the court will have found that their conduct falls within one or more of the exceptions to the limitation.

jority of the shares voted on the SOP proposal were voted against the proposal, the shareholders must have concluded that the compensation paid to the executives was not in the shareholders' best interests and, therefore, the presumption under the business judgment rule that the directors acted in the best interests of the shareholders is rebutted, or at least constitutes evidence that must be heard at trial.[52] Several of the complaints attempt to bolster this argument by pointing out that the company has sophisticated institutional shareholders who voted against the SOP proposal based on the information presented in the proxy statement, which they allege is the same information on which the board based its decision to approve the compensation.[53]

A motion to dismiss the complaint in Beazer Homes was granted in September 2011.[54] The dismissal order points out two fatal flaws in this argument. First, the business judgment rule does not presume that the action taken by the directors was in the best interests of shareholders; it presumes that the *directors honestly believed, when they took the action,* that the action was in the best interests of shareholders.[55] That the shareholders may disagree after the fact says nothing about the directors' state of mind when they determined to grant executive compensation. The business judgment rule is designed to protect board decisions from being second-guessed with 20/20 hindsight.[56]

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52. *See, e.g.*, Order Granting Defendant's Motions To Dismiss The Complaint, Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy, No. 2011cv197841, 2011 WL 5113531, at *10-11 (Ga. Super. Ct. Sept. 16, 2011) [hereinafter Beazer Homes Order].

53. *See, e.g.*, Cincinnati Bell Complaint, *supra* note 21, at *17. In this author's experience, a significant amount of detailed information is typically provided to the board in connection with its executive compensation decisions – certainly more than what is included in the CD&A section of the proxy statement.

54. Beazer Homes Order, *supra* note 52 at *10-11. Some of the other SOP cases have also received action favorable to the defendants. The PICO Holdings case, which was removed to the U.S. District Court for the Southern District of California, was dismissed as to the fiduciary duty claim and remanded to state court, specifically rejecting the argument that the SOP vote rebuts the business judgment rule. *See generally* PICO Holdings, Inc., *supra* note 22. The Umpqua Holdings case has been dismissed pending amendment of the complaint no later than March 26, 2012. *See generally* Umpqua Holdings Complaint, *supra* note 21. The Jacobs Engineering Group, Inc. Consolidated Shareholder Derivative Litigation case has been dismissed without opinion. *See* Paul Bessette, Royale Price, & Adam Swick, *Keeping Current – 2012 Outlook for Say-on-Pay Lawsuits*, BUS. L. TODAY (Feb. 2012), http://apps.americanbar.org/buslaw/blt/content/2012/02/keepingcurrent-01.shtml. Bessette's article also provides a brief summary of these recent decisions. *Id.* Keycorp and Occidental Petroleum, which were filed in 2010, have been settled, the former at a cost of $1.75 million. *See* Keycorp, Current Report (Form 8-K) (Mar. 25, 2011).

55. Beazer Homes Order, *supra* note 52, at *10-11.

56. Although not specifically addressed in the Beazer Homes Order, state law typically permits the board, in exercising its business judgment, to rely in good faith on the advice of experts, including in connection with decisions relating to executive compensation, with respect to matters within the expert's expertise. These statutes provide further

Second, the argument ignores the statutory language in the Dodd-Frank Act that the SOP vote may not be construed as overruling a decision by the board, changing the board's fiduciary duties, or creating any additional fiduciary duties for the board.[57] Although the negative SOP advisory vote may be evidence of a difference of opinion between the board and the shareholders on the subject of executive compensation, the power to determine executive compensation belongs to the board and not the shareholders under state corporate law.[58] Thus, an advisory SOP vote by shareholders cannot usurp the board's authority with respect to compensation decisions.[59]

To hold otherwise would expose the directors to potential personal liability whenever a subsequent shareholder vote disagrees with a prior decision. Such exposure would have a chilling effect on actions by the board on which the shareholders vote and would discourage otherwise qualified individuals from serving as directors of public companies. For example, public companies routinely ask shareholders to ratify the appointment of the company's independent auditors as a matter of good governance. If shareholders were to vote against the ratification proposal, the audit committee members could, under this rationale, be personally liable for a breach of fiduciary duty for having appointed the rejected independent auditors and perhaps be expected to reimburse the company for fees and expenses paid to the auditor, particularly if the audit committee determines not to replace the independent auditing firm despite the shareholders' failure to ratify the appointment. Similarly, a merger proposal submitted to and rejected by the shareholders could potentially result in personal liability for the board for the related expenses, which are often substantial. Such a holding would

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protection for boards that engage an independent compensation consultant and justifiably rely on the advice received. *See* Brehm v. Eisner, 746 A.2d 244, 261 (Del. 2000); DEL. CODE. ANN. tit. 8, § 141(e) (West 2011); MICH. COMP. LAWS ANN. § 450.1541(a) (West 2012).

57. Beazer Homes Order, *supra* note 52, at *11; *see also supra* text accompanying note 50.

58. Beazer Homes Order, *supra* note 52, at *12. The argument misconstrues a fundamental principle of corporate governance: a corporation's business is managed by its board, not by its shareholders. General Corporation Law, DEL. CODE ANN. tit. § 141(a) (2012); *see also* MICH. COMP. LAWS § 450.1501 (2012). A shareholder who disagrees with the manner in which the board manages the business may vote the board out of office or "vote with their feet" by selling their stock. *Id.*

59. This outcome is in contrast to a situation in which the shareholder vote is not merely advisory, such as when (1) the board approves a matter, but provides, as a condition to the company's ability to proceed on the matter, that shareholder approval must be received, in effect ceding some of its power to the shareholders, or (2) state law requires both board and shareholder approval in order to proceed, such as in connection with a merger.

raise the risk level for directors and increase the incentive for companies to settle these cases to limit the exposure.[60]

Though it would seem unlikely that any of these claims could succeed at trial unless the court was willing to ignore the business judgment rule and the statutory rule of construction in Section 951(c) of the Dodd-Frank Act, liberal notice pleading standards or other factors may result in a case surviving a motion to dismiss, as was the case in Cincinnati Bell.[61] In that case, on essentially the same allegations as outlined above, and despite a standard of proof that was even higher than the Delaware standard applied in Beazer Homes,[62] the court issued an order denying defendants' motion to dismiss, stating that "the business judgment rule imposes a burden of proof, not a burden of pleading" and that "while a plaintiff must plead an exception to the business judgment rule, he is 'not required to plead the exception with particularity'" under federal pleading rules.[63] The court then held that the complaint provides "factual allegations and not simply conclusory allegations" that "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."[64] In a footnote, the court points to plaintiff's assertion that the negative SOP vote is evidence that the compensation decisions were not in the shareholders' best interests as support for its statement regarding the sufficiency of plaintiff's claim.[65]

That the Cincinnati Bell court was even willing to allow this case to proceed to discovery on these allegations increases the uncertainty and risk

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60. Most companies' charter provisions that limit directors' monetary liability would also require proof of a breach of duty of loyalty or bad faith in order to impose monetary liability. As a result, the extent of the risk to directors is not entirely clear.

61. Order Denying Defendant's Motion To Dismiss, NECA-IBEW Pension Fund ex rel. Cincinnati Bell v. Cox, No. 1:11-cv-451, 2011 WL 4383368 at *2 (S.D. Ohio Sept. 20, 2011) [hereinafter Cincinnati Bell Order]. A derivative action against Cincinnati Bell, with similar claims filed in Ohio state court was settled, subject to final court approval. *In re* Cincinnati Bell Inc. Derivative Litigation, Case No. A1105305 (Ohio Ct. Com. Pl. 2011); *see* Cincinnati Bell Inc., Current Report (Form 8-K) (Jan. 18, 2011), *available at* http://www.sec.gov/Archives/edgar/data/716133/000071613312000005/0000716133-12-000005-index.htm.

62. Under Ohio law, in applying the business judgment rule, directors will face liability only if it is shown by "clear and convincing evidence" that their actions were undertaken with a "deliberate intent to cause injury to the corporation" or a "reckless disregard for the best interests of the corporation," OHIO REV. CODE ANN. §1701.59(D) (West 2011).

63. NECA-IBEW Pension Fund ex rel. Cincinnati Bell, 2011 WL 4383368 at *2.

64. *Id*. at *3.

65. *Id*.

of bad publicity and burdensome legal expenses, which in turn increases the plaintiff's leverage to force the company to settle the case for an amount covering the plaintiff's substantial attorneys' fees. The company may in that event be able to make a claim against the company's directors and officers liability insurance coverage, reducing the short-term financial impact on the company, but likely making its future insurance coverage more expensive. Shareholders and the company are actually disadvantaged by such a suit as a result of:

1. The distraction the suit represents to the defendant directors who must expend a portion of their limited time and energy on matters relating to the suit rather than overseeing the company's business;
2. The bad publicity relating to the suit for the company, which could have a negative effect on the market price for the company's stock;
3. The expenses associated with defending the litigation (at minimum, the applicable insurance deductible) and with the subsequently higher premiums for director and officer liability insurance; and
4. The resulting disincentive to qualified persons to become directors of the company, and for the current directors to remain directors, due to the heightened risk of personal liability.[66]

When such lawsuits have little chance of succeeding at trial and providing any financial or other benefit to the company in light of the business judgment rule, but there is otherwise sufficient impetus to force a settlement, the net result is that the plaintiff bar gains at the expense of the company and the shareholders - quite the opposite of the intended result of a derivative action, and contrary to public policy.

III. APPLYING THE LESSONS LEARNED

In view of the litigation risk relating to a negative SOP vote, particularly in light of Cincinnati Bell, obtaining a positive SOP vote is more important than ever,[67] though it may be more difficult to accomplish in 2012

66. If the court finds a breach of duty of loyalty and/or bad faith, the directors may not be covered by directors and officers liability insurance or the indemnification provisions in the company's charter or bylaws nor protected by the charter's limitation on monetary liability, meaning any monetary damages may have to be funded directly from the individual directors.

67. Despite overwhelming support for its SOP proposal, The Bank of New York Mellon Corporation directors were sued for breach of fiduciary duty regarding their compensation practices, so a positive SOP vote is not guaranteed to be litigation repellant. *See, e.g., Unlucky #7: A Quasi-Say-on-Pay Lawsuit*, THE CORPORATE COUNSEL (June 27, 2011), http://www.thecorporatecounsel.net/Blog/2011/06/house-financial-services-committee-approves-1.html (last visited Apr. 13, 2012).

due to the lackluster performance of U.S. equities in 2011. The positive results in 2011 may have been due in large part to market performance during 2010, which saw the Russell 3000 index rise 16.9%,[68] and may have lulled some companies into a false sense of security. Shareholders who may have been inclined to look favorably upon SOP proposals in 2011 when the value of their investments was on the rise in 2010, may be less inclined to do so in 2012 when 2011 stock performance was generally flat.[69] Also, many companies whose SOP proposal passed had high broker non-vote counts due to the failure of many shareholders who hold shares in brokerage accounts to give voting instructions to their brokers.[70] Where the positive vote was weak and the broker non-vote count was high, shareholders who did not give instructions to their broker in 2011 on how to vote their shares on SOP may decide in 2012 to use the SOP vote to express their dissatisfaction with the stock performance and swing the vote to negative, even if those who voted last year vote the same way in 2012.[71]

In view of these factors, a high positive vote in 2011 does not guarantee a positive vote in 2012, even if the compensation program does not change. Thus, it seems prudent to review the lessons learned from the actions taken by companies to prepare for their SOP vote and the results of those actions in 2011, and consider how those lessons may be applied in 2012.[72]

Lesson 1. Proxy advisor recommendations tended to move the vote significantly, particularly in light of the reduction in total shares voted due to the concurrent change in broker uninstructed voting rules. While the average vote in favor of an SOP proposal was 92%, the vote averaged only 65% in fa-

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68. *Russell Index Returns Calculator*, RUSSELL INVESTMENTS, http://component.russell.com/00001/indexcalculator/ICStep4DR.aspx (last visited Apr. 11, 2012).

69. *Id*. The return on the Russell 3000 Index in 2011was a a mere 1.03%. *Id*.

70. *See* 15 U.S.C.A. § 78f. (West 2010). Section 957 of the Dodd-Frank Act required national securities exchanges to modify their rules to prevent member organizations from voting shares held on behalf of a beneficial owner on matters relating to compensation (including SOP proposals) without instructions from the beneficial owner. Id. New York Stock Exchange Rule 452 implements this change as required. N.Y.S.E. Rule 452 (V.A.B.C.A. 2012).

71. For example, at a company with 1,000 shares outstanding, if in 2011 the company had 360 votes for the SOP proposal, 240 against and 400 broker non-votes, the vote would change from a positive result to a negative result if just 31% of the broker non-vote shares are voted against the 2012 proposal, and the remaining shareholders vote in 2012 as they did in 2011.

72. These lessons are also discussed in a client alert drafted by the author. *See 2012 Proxy and Disclosure Planning Alert,* DYKEMA (Jan. 2012), www.dykema.com/resources-alerts-proxy_disclosure-planning-alert_1-2012.html.

vor if the company's SOP proposal received a negative vote recommendation from ISS.[73] Moreover, all of the companies at which the SOP proposal received fewer votes for than against, and on which ISS made a recommendation, received a negative vote recommendation from ISS.[74] The negative vote recommendations from ISS were primarily due to a "pay-for-performance disconnect" or to "problematic pay practices."[75] While it is difficult to address pay-for-performance issues after the fact,[76] companies should consider comparing their compensation and policies to ISS guidelines to determine whether any changes should be made prior to the 2012 proxy season. In particular, to reduce potential ISS objections, companies should consider eliminating those practices that ISS defines as "problematic pay practices" like tax gross-ups, certain perquisites such as country club memberships and financial planning allowances, and oversized or single trigger change in control arrangements.[77] According to a re-

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73. S*ee* Charles Nathan et al., *Say on Pay 2011: Proxy Advisors on Course for Hegemony*, N.Y.L.J. (Nov. 28, 2011), http://www.newyorklawjournal.com/PubArticleNY.jsp?id=1202533268910&slreturn=1 (discussing the increasing power of proxy advisors).

74. The SOP proposal at Premiere Global Services, Inc. received no recommendation. *See* Semler Brossy Consulting Grp., *2011 SAY ON PAY RESULTS: RUSSEL 3000* (Aug. 26, 2011), *available at* http://www.semlerbrossy.com/wp-content/uploads/2012/04/SBCG-SOP-2012-04-11.pdf. Also, according to correspondence from ISS received by the author, ISS made a negative recommendation on the SOP proposal at the March 2011 annual meeting of Hemispherx Biopharma, Inc., where the vote could be construed to have defeated the SOP proposal. The Form 8-K and related press release filed by Hemispherx disclosing the results of the voting at the meeting reports that the SOP proposal passed, with a slight majority of the votes cast for and against the proposal having approved the SOP proposal. If the methodology outlined in the Hemispherx proxy statement is used to count the votes, however, abstentions would be treated as shares voted and the SOP proposal would not have received the affirmative vote of a majority of the shares voted. Hemispherx Biopharma, Inc., *Hemispherx Biopharma Press Release for Tuesday, March 22, 2011*, HEMISPHERX.NET, http://www.hemispherx.net/content/investor/default.asp?goto=702 (last visited Apr. 3, 2012).

75. ISS Report, *supra* note 13, at 7.

76. Other than with additional disclosure. *See infra* note text accompanying 92.

77. Russell Miller & Yonat Assayag, *SOP Drives Compensation Program Changes to Enhance Pay/Performance Link*, THE CONFERENCE BOARD, Sept. 2011, at 1, 1-3, *available at* http://clearbridgecomp.com/wp-content/uploads/TCB_DN-V3N18-11.pdf. "Problematic pay practices" as defined by ISS in its 2011 U.S. Proxy Voting Guidelines include (a) repricing or replacing of underwater stock options or stock appreciation rights without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options); (b) excessive perquisites or tax gross-ups, including any gross-up related to a secular trust or restricted stock vesting; (c) new or extended agreements that provide for (1) change in control payments exceeding three times base salary and average/target/most recent

cent Towers Watson survey, nearly one-third of the companies surveyed made changes to their pay programs in anticipation of the 2011 SOP vote and 38% are considering changes in compensation programs for 2012.[78]

Lesson 2. Despite the general tendency of institutional shareholders to follow or at least consider the voting advice of proxy advisors such as ISS and Glass Lewis, talking about executive compensation with voting decision makers at institutions holding the company's stock before the proxy solicitation process began was believed to have been successful in helping to sway institutional shareholder votes.[79] More than half of the companies recently surveyed by Towers Watson reached out to their shareholders in advance of the SOP vote in 2011.[80] Communication with shareholders before the annual meeting and even before the proxy season can also provide an early indication of whether the company is at risk of losing on its SOP proposal. Knowing how its largest shareholders are leaning may provide an opportunity for the company to make changes to its compensation program, or even to individual grants, in time to avoid a negative vote, or may cause the company to actively solicit proxies after filing the proxy statement. According to the Towers Watson survey, 40% of companies hired a proxy solicitor to assist with communications and provide information during the proxy solicitation process.[81]

Lesson 3. Listening to investors is also vital to companies' efforts to respond to shareholder concerns. ISS has indicated that in 2012, with respect to companies that received less than 70% approval their 2011 SOP proposal, it will review the

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bonus; (2) single trigger or modified single trigger change in control severance payments (without involuntary job loss or substantial diminution of duties); or (3) change in control payments with excise tax gross-ups; (d) incentives that may motivate excessive risk-taking; and (e) option backdating. *Id*. According to the study by ClearBridge Compensation Group, LLC for The Conference Board of the first 100 proxy filings by Fortune 100 companies in 2011 that were subject to SOP votes, 46% of such companies reduced or eliminated such items prior to the 2011 proxy season. *Id*.

78. Richard Luss, Todd Manas, & Stever Seelig, *Executive Compensation Bulletin*, TOWERS WATSON, 3 (Aug. 12, 2011), http://www.towerswatson.com/assets/pdf/5242/EC-Bulletin-Seelig-Manas-Luss.pdf.

79. *Id*.

80. *Id*. at 1.

81. *Id*. at 4.

actions of the compensation committee on a case by case basis and, if found to be unresponsive to shareholder concerns regarding compensation practices, will recommend a vote against the 2012 SOP proposal and against the committee members' reelections.[82] All companies will need to include disclosure in their annual meeting proxy statement regarding whether and how the board of directors or compensation committee took into account the SOP vote.[83] In light of this requirement, understanding investor concerns regarding compensation will be critical to companies' efforts in determining how to respond to a low vote or a "no" vote, as well as to companies intent on avoiding such a result.

Lesson 4. Dozens of companies who received a negative vote recommendation from ISS in 2011 filed supplemental proxy materials making a case to shareholders why they believe the ISS recommendation was wrong, primarily taking issue with the ISS conclusion that the company had a "pay-for-performance disconnect."[84] ISS's analysis of performance was based primarily on a review of the chief executive officer's total compensation in light of a comparison of the company's one and three year total shareholder return with the results of a broad peer group.[85] Anecdotally, it appears that companies' efforts to sway votes by pointing out the shortcomings of such a narrow analysis were often successful. Moreover, in response to feedback received through its corporate governance policy comment process and otherwise, ISS has revised its approach to evaluating pay for performance alignment means for purposes of its 2012 voting guidelines.[86] While still using total shareholder return as the primary basis, ISS has refined its analysis in several respects for 2012 and will take into ac-

82. ISS 2012 Updates, *supra* note 17, at 8. Also, one of the allegations typically made in the SOP litigation complaints is that in the weeks or months after the annual meeting prior to the filing of the complaint, the board did not respond to the negative SOP vote by rescinding the "excess pay" or modifying the company's pay practices.

83. 17 C.F.R. § 229.402(b)(1)(vii) (2011).

84. *See* Semler Brossy Consulting Grp., *2011 SAY ON PAY RESULTS: RUSSELL 3000* 6-14 (Aug. 26, 2011), *available at* http://www.semlerbrossy.com/wp-content/uploads/2012/04/SBCG-SOP-2012-04-11.pdf (providing a comprehensive review of these materials).

85. INSTITUTIONAL SHAREHOLDER SERVICES INC., 2012 U.S. PROXY VOTING SUMMARY GUIDELINES 38 (2012).

86. ISS 2012 Updates, *supra* note 17, at 10.

count other performance factors in its qualitative analysis under certain circumstances.[87] Due to the susceptibility of the market price to forces outside of management's control, companies are likely to continue defining "performance" for purposes of incentive award conditions without reference to total shareholder return, instead using financial and operational measures relevant to the company that the compensation committee believes drive results.[88] Companies should be prepared to address shareholder criticisms of their compensation practices or particular compensation decisions, as well as weaknesses in the ISS analysis underlying a negative vote recommendation to counteract the negative effect of an ISS negative vote recommendation.

Lesson 5. Shareholders are more likely to cry foul if there are large year-over-year increases in total executive compensation when stock performance has not been positive, and such increases can act as a catalyst for shareholder dissension and a negative SOP vote.[89] Nearly all of the companies that had a negative SOP vote in 2011 experienced a decrease in their stock price between December 2007 and December 2010, and many experienced a decrease during 2010.[90] In the SOP litigation complaints, plaintiffs often focused on the total compensation column in the proxy statement's summary compensation table to make the case that executives received large pay increases when in fact the total may have increased due to changes in a pension benefit estimate, to "catch-up" compensation increases delayed from prior years due to expense cutting efforts, or to meeting operational incentive goals that did not translate into short term stock appreciation.[91] Boards should be sen-

87. *Id.* at 9-11. *See* GARY HEWITT & CAROL BOWIE, INSTITUTIONAL SHAREHOLDER SERVICES INC., EVALUATING PAY FOR PERFORMANCE ALIGNMENT: ISS' QUANTITATIVE AND QUALITATIVE APPROACH (2011) (discussing the updates in further detail).

88. Of course, the value of equity-based awards is tied, at least in part, to the future value of the underlying common stock, one component of the total shareholder return calculation.

89. Total CEO compensation is also the figure analyzed by ISS in connection with its pay-for-performance analysis. *See* ISS REPORT, *supra* note 13, at 9-11.

90. Based on closing stock price data collected from Yahoo[R] Finance for these companies.

91. *See, e.g.*, UMPQUA HOLDINGS CORP., DEFINITIVE PROXY STATEMENT (2011), *available at* http://www1.snl.com/Cache/10801151.pdf?O=3&IID=4047103&OSID=9&FID=10801151 (discussing adjustments after TARP-related requirements no longer applicable, in accordance with a peer group comparison); CINCINNATI BELL, DEFINITIVE

sitive to this dynamic and do what they can to avoid large year-to-year increases in total compensation or have a well reasoned and documented rationale for the increase that is clearly explained in the CD&A.

Lesson 6. A company should use the CD&A as an opportunity to tell shareholders and those who advise them why the company paid the compensation it paid, going beyond simple compliance with the applicable SEC requirements.[92] While rule compliance is obviously important, commentators believe that part of companies' success in obtaining an overwhelmingly positive SOP vote in 2011 was attributable to improvements made in their CD&A to make it more persuasive and shareholder-friendly.[93] Here are a few specific suggestions:[94]

1. Begin the CD&A with a brief executive summary of the discussion, focusing on explaining why the company paid what it paid and the link between pay and performance.[95] Discuss the company's performance highlights briefly and include actions

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PROXY STATEMENTS (2011), *available at* http://investor.cincinnatibell.com/phoenix.zhtml?c=111332&p=irol-sec&seccat01.1_rs=21&seccat01.1_rc=10 (discussing the increase in CEO compensation due to large retention bonus requiring continued employment for two additional years and in pension value based on higher service eligible income).

92. According to the Towers Watson Survey, 41% of companies are devoting more attention and effort to the company's CD&A section of the 2012 annual meeting proxy statement and 13% said their board is more engaged in developing the CD&A section. Richard Luss, Todd Manas, & Stever Seelig, *Executive Compensation Bulletin*, TOWERS WATSON, 3 (Aug. 12, 2011), http://www.towerswatson.com/assets/pdf/5242/EC-Bulletin-Seelig-Manas-Luss.pdf.

93. *See, e.g.,* Mary Schapiro, Chairman, Sec. and Exch. Comm'n., Speech by SEC Chairman: Remarks to TheCorporateCounsel.Net "Say-on-Pay Workshop Conference" (Nov. 2, 2011). Various law firm memoranda also suggest that changes to the annual meeting proxy statement's compensation disclosures were helpful in winning shareholder votes. Good compensation-related disclosure may also be instrumental in convincing ISS to give a positive SOP vote recommendation when the quantitative analysis based on total shareholder return otherwise indicates a pay-for-performance disconnect. *See* ISS REPORT, *supra* note 13, at 9-11.

94. George Paulin, *Five 'Say on Pay' Lessons*, BLOOMBERG BUSINESSWEEK (July 29, 2011), http://www.businessweek.com/management/five-sayonpay-lessons-07292011.html.

95. According to a study by ClearBridge Compensation Group, LLC for The Conference Board of the first 100 proxy filings by Fortune 100 companies in 2011 that were subject to SOP votes, 35% of such companies added executive summaries to their 2011 proxy statement, and another 30% continued to include such a summary as they had in the prior year. "SOP Drives Compensation Program Changes to Enhance Pay/Performance Link," *supra* note 77.

taken by the company and other factors that shareholders and ISS will view favorably in performing their analysis of the company's executive compensation practices. The summary is particularly important given that it may be the only portion of the CD&A shareholders will take time to read.

2. Go beyond the SEC's requirements, using graphs and tables where necessary to pointedly illustrate how the company based a significant portion of compensation on performance and, if performance was not at or above target, how compensation actually paid decreased as a result. Explain what performance measures were used and why those particular measures were used. Also, explain decisions to increase non-performance based pay, indicating the retention or other factors supporting the board's decisions and how the decisions served shareholder interests.

3. Avoid broad generalizations and boilerplate that could be cherry-picked by a plaintiff's lawyer in a suit challenging the board's compensation decisions. Make the discussion a nuanced explanation specific to the company. In the SOP litigation to date, the complaints have drawn heavily from the CD&A section of the annual meeting proxy statement.[96] Broad statements about a pay-for-performance philosophy, generic explanations, inconsistencies and other imprecise language are most likely to be pulled out of context and used against the board.

4. Be concise. Avoid repetition and unnecessary detail that will only lengthen the CD&A and serve to discourage shareholders from reading it and use simple, plain English to make the discussion accessible to ordinary shareholders.

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96. *See* discussion *supra* Part II (discussing SOP litigation); *see also* Complaints *supra* notes 21, 22.

Lesson 7. In view of the heightened threat of litigation, companies should closely follow fundamental governance principles of independence and process so that the board is in the best position possible to defend its compensation decisions. Actions to take in this regard include the following:

1. Be sure executive compensation decisions are being made only by a committee of independent directors with no conflicts of interest and avoid domination of the compensation process by management.

2. Have the compensation committee hire an independent consultant who reports only to the committee, and have the committee obtain the consultant's written and verbal report when making compensation decisions to further support the record that the committee acted with due care and in reliance on an expert.

3. Distribute written materials relating to compensation decisions in advance of the meeting and have the materials presented at the committee's meeting by the consultant or management.

4. Draft minutes assuming they will be discovered in litigation. Show that the committee acted deliberately and diligently, document the committee's rationale for its decisions, link decisions to the advice received, and avoid unnecessary detail that could be misconstrued or otherwise used against the board.

CONCLUSION

The first year of mandatory say on pay resulted in an overwhelmingly positive response from shareholders. However, say on pay should remain an important issue for public companies as most prepare for another SOP vote in 2012. A failed or marginally favorable SOP vote, despite being merely an advisory vote, increases the risk of shareholder litigation against the company's directors and can have ancillary consequences for the reelection of compensation committee members and other directors if the response by the company to the compensation issues raised by shareholders is not sufficient. Moreover, the flat or negative trend in stock prices in 2011 could cause votes to swing from positive to negative in 2012. The risk of a negative vote will only increase as election year class warfare rhetoric and media coverage of so-called "occupier" protests continue to receive significant attention in the mainstream media. As a result, companies should remain vigilant and act on the lessons learned in 2011 to minimize the risk of a negative SOP vote and shareholder litigation.