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Ohio District Court has Its Say on Say-on-Pay

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Public companies are now required to provide shareholders with an advisory "say-on-pay" vote on resolutions regarding the compensation of the company's named executive officers, under the new rules adopted by the Securities and Exchange Commission ("SEC") in early 2011 under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). Under the express provisions of the Dodd-Frank Act, this shareholder vote is advisory only and not binding on the company, and does not overrule any decisions of the board or create or imply a change or addition to the fiduciary duties of the company's directors.

Despite this unambiguous language in the federal statute and SEC rules, fiduciary breaches are traditionally within the purview of state law. Various shareholder derivative lawsuits have been filed since January 2011 with respect to public companies whose shareholders voted as a majority against the company's executive compensation program.

Plaintiffs in these cases generally have alleged:

- Breaches of the fiduciary duties of loyalty and good faith, by both directors and individual executive officers in approving an excessive compensation program
- Directors engaged in an invalid exercise of business judgment
- Corporate waste by directors
- Both directors and individual executive officers made false and misleading misrepresentations, by stating in SEC filings that the company had a "pay for performance" policy, but in fact increasing compensation regardless of poor company performance
- Unjust enrichment of individual executive officers
- Individual executive officers and the compensation consultants advising the board aided and abetted the directors' breaches of fiduciary duty, and/or
- Breach of contract to render "competent and sound" advice, by compensation consultants advising the board

Recently, two such shareholder derivative suits have been dismissed by courts applying Delaware law, in part based on the principle that the negative say-on-pay vote alone was not sufficiently probative evidence to rebut the business judgment rule (which generally protects directors by creating the presumption that they have acted on an informed basis, honestly and in good faith). (*In re The Goldman Sachs Group, Inc. Shareholder Litigation,* C.A. No. 5215-VCG (Del. Ch. Oct. 12, 2011); *Teamsters Local*

237 Additional Security Benefit Fund v. McCarthy, Case No. 2011-cv-197841 (Ga. Super. Ct. Sept. 16, 2011)).

However, in September 2011, a shareholder derivative suit brought in a Cincinnati federal district court survived a motion to dismiss under Ohio law (*NECA-IBEW Pension Fund, derivatively on behalf of Cincinnati Bell, Inc. v. Cox*, No. 1:11-cv-451 (S.D. Ohio Sept 20, 2011)). Citing the fact that the majority of Cincinnati Bell shareholders voted against the executive compensation program in 2011, and that the company had approved large pay raises and bonuses in a year when the company was not performing well, the plaintiffs alleged that the board of directors had breached the duty of loyalty, the compensation consultants had aided and abetted that breach, and that certain executives had been unjustly enriched as a result. The court has allowed the case to move forward, stating that the plaintiffs' factual allegations raise a plausible claim that the compensation program was not in the best interests of the company's shareholders and constituted an abuse of discretion. Further, the court allowed the claim of unjust enrichment to proceed, because the plaintiffs had sufficiently pled facts for a breach of fiduciary duty.

Despite the other rulings to the contrary, the *Cincinnati Bell* decision is problematic in that it may encourage more shareholder derivative suits to be brought in the future against companies with negative say-on-pay votes. In light of this increased risk, we continue to recommend that our public company clients:

- Coordinate with counsel to carefully prepare clear disclosures explaining the company's compensation programs and the compensation of its named executive officers, paying special attention to discussion of pay-for-performance policies
- Consider a shareholder outreach program to improve investor relations and identify any problematic executive compensation practices
- Review the existing executive compensation program and modify, to the extent possible, any particular practices or compensation decisions that would reasonably be expected to result in a negative shareholder reaction