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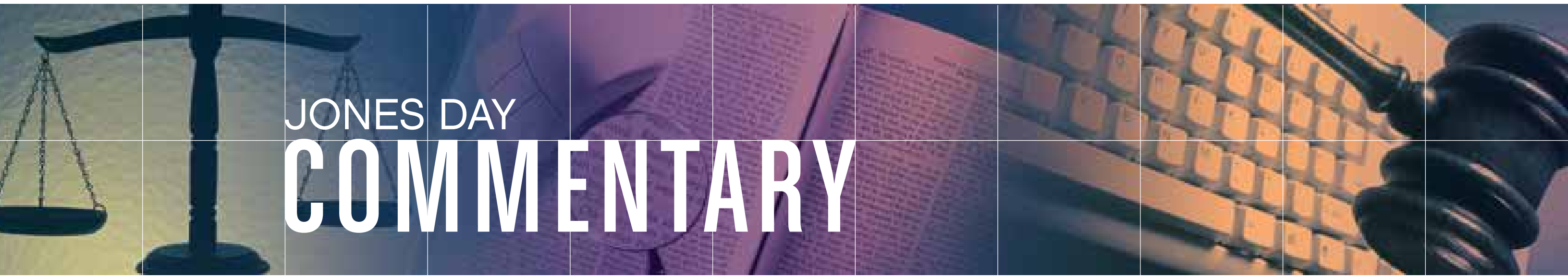

CALIFORNIA APPEALS COURT AFFIRMS DISMISSAL OF "SAY ON PAY" DERIVATIVE LAWSUIT

The Dodd-Frank Act,[1] enacted by Congress in 2010, contains a "say on pay" provision that requires public companies to submit their executive compensation arrangements to advisory shareholder votes. Even though the statute explicitly states that these votes are nonbinding and do not alter the fiduciary duties of directors, in the past few years, shareholders have filed derivative lawsuits against the boards of many companies that lost a "say on pay" vote. Most courts have dismissed these cases for failure to adhere to the requirements for shareholder derivative litigation. A California court has now issued the first appellate decision affirming the dismissal of such a case,[2] putting another nail in the coffin of these misguided legal actions.

DODD-FRANK'S "SAY ON PAY" PROVISION

Section 951 of the Dodd-Frank Act requires public companies to include in their proxy statements "a separate resolution subject to shareholder vote to approve the compensation of executives…."[3] The resolution is to be submitted to shareholders every one, two, or three years; the frequency of submission is determined by a separate shareholder vote that must be held at least once every six years.[4] The statute expressly states that the vote is only advisory, and that it "may not be construed … to create or imply any change to the fiduciary duties of such issuer or board of directors … [or] to create or imply any additional fiduciary duties for such issuer or board of directors…."[5] Based on this language, most commentators opined that the primary significance of the "say on pay" provision was to give shareholders a way to express their views. Companies were advised to build support for their proposals in advance and, in the event of a negative vote, to consider whether their plans should be revised in the future. It was the general consensus that a shareholder vote against a plan should not be the basis for litigation against the directors who adopted it.

Opportunistic plaintiffs' attorneys, however, soon began targeting companies whose shareholders had cast the majority of their advisory votes against a compensation proposal. The typical case took the form of a derivative complaint in which the shareholder plaintiff alleged that the negative vote established that the company's directors had breached their fiduciary duties and should be liable in damages to the company. Although shareholders who wish to proceed with a derivative claim are generally required to make a demand on the board before filing suit, most plaintiffs in these cases declined to make a pre-suit demand, claiming that demand was excused because it would be "futile" to demand corrective action from the very directors who were asserted to be liable.

In nearly all of these cases, the courts dismissed the complaints, usually because the plaintiffs had failed to make a pre-suit demand and had failed to sufficiently allege that demand should be excused. Until now, however, no appellate court had ruled on the validity of these claims.

THE *JACOBS ENGINEERING* CASE[6]

In May 2010, Jacobs Engineering Group, Inc. adopted an executive compensation plan with input from an outside compensation consulting firm. In December 2010 and January 2011, Jacobs filed proxy materials describing the plan in connection with a "say on pay" proposal to approve the plan at the upcoming annual meeting. Institutional Shareholder Services, Inc. recommended that shareholders vote against the proposal, and at the annual meeting in January 2011, 55.2 percent of the shareholders voted against it.

Three shareholders filed a derivative suit challenging the board's adoption of the plan. The plaintiffs alleged that even though the plan stated that it was designed to link compensation to the corporation's performance, in reality it increased executive pay by substantial amounts even as the company was experiencing weak financial performance. Plaintiffs also alleged that Jacobs's proxy materials overstated the company's performance compared to a self-selected group of peer companies, giving a misleading picture of its relative performance.

Plaintiffs asserted claims for breach of fiduciary duty and making misleading statements against all 11 members of Jacobs's board, and they asserted claims against the compensation consulting firm for aiding and abetting these breaches and for breach of contract. The defendants moved to dismiss the amended complaint, and the trial court granted the motions.

THE COURT OF APPEAL'S DECISION AFFIRMING DISMISSAL

Like most states, California requires that a shareholder filing a derivative suit allege that he or she has made demand on the board to secure the relief he seeks or the reasons for failing to make demand.[7] The shareholder plaintiffs alleged that they did not make pre-suit demand on the board because it would have been futile to do so.

Because Jacobs is incorporated in Delaware, the "internal affairs doctrine" required the Court of Appeal to apply Delaware law to determine whether the plaintiffs had sufficiently stated a claim for relief. Delaware requires that in order to excuse the demand requirement, a derivative complaint must set forth specific facts creating a "reasonable doubt" that the directors are "disinterested and independent" or that their action was the result of a "valid exercise of business judgment."[8] Broad, nonspecific accusations of bias or wrongful conduct are not sufficient; the plaintiff must set forth specific facts on a director-by-director basis.

The Court of Appeal, observing that the Delaware standard is "strict," disposed of each of the plaintiffs' claims of director bias or wrongdoing. The court concluded that the complaint did not support a reasonable doubt about director independence, since 10 of the 11 directors were outside directors not covered by the compensation plan, and the only executive on the board did not have a controlling interest in the corporation. Nor were the plaintiffs able to raise any doubt about the "disinterestedness" of the board; the mere threat that a director might face liability for a decision was an insufficient basis to raise such a doubt. Finally, the court found no basis to challenge the adoption of the plan as a valid exercise of business judgment. Following the analysis of a recent federal district court case from Delaware,[9] the court found that it was the plaintiffs who had mischaracterized the goals of the plan as described in the proxy materials. The court also reaffirmed that the plaintiffs had failed to recognize the "realities" that the "say on pay" provisions of Dodd-Frank were intended to be nonbinding and not intended to create or change directors' fiduciary duties.

Ultimately, the Court of Appeal agreed with the lower court that the plaintiffs had failed to set forth sufficient facts to support their claim that demand on the board should be excused. Although its ruling was based on a procedural ground, the court left little doubt as to how it viewed the substance of the plaintiffs' claims.

WHAT THE DECISION MEANS FOR PUBLIC COMPANIES

For the past three years, public companies have seen shareholder plaintiffs argue that the "say on pay" provisions of Dodd-Frank give them a right to "sue on pay." Fortunately, nearly every court that has examined shareholder claims based on an unsuccessful "say on pay" vote has rejected them. With the *Jacobs Engineering* decision, the only appellate court to have examined these claims has rejected them as well. It appears that the courts have properly recognized that the question of executive compensation should remain one for dialogue between corporations and their shareholders—a dialogue in which the courts generally have no place, as Congress quite clearly intended. It is not surprising, then, that few if any "say on pay" cases have been filed in recent months.

None of this is to suggest, however, that the "say on pay" provisions are without force. Because Dodd-Frank requires periodic shareholder votes, shareholders will continue to have opportunities to express their views on executive compensation. Corporations will do well to engage their shareholders on the subject, to listen to their voices, and to learn from and, where appropriate, respond to what they hear. The good news from the courts, however, is that this conversation will, for the most part, occur without judicial intervention.

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ENDNOTES

1 Pub. L. 111-203, enacted July 21, 2010.

2 *Charter Township of Clinton Police and Fire Retirement Sys. v. Martin*, 13 C.D.O.S. 10384 (Cal. 2d Dist. Ct. App., No. B241087, Sept. 17, 2013) ("*Jacobs Engineering*").

3 Section 951 is codified at Section 14A of the Securities Exchange Act of 1934, 15 USC § 78n-1.

4 5 USC § 78n-1(a)(2).

5 15 USC § 78n-1(c)(2)-(3).

6 All of the facts are taken from the court's opinion, *supra* note 2.

7 Cal. Corp. C. § 800(b)(2).

8 *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), *overruled on other grounds in Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

9 *Raul v. Rynd*, U.S. Dist. LEXIS 35256 (D. Del., Mar. 14, 2013).