

Perceived Pay-for-Performance Disconnect Brings Say-on-Pay Shareholder Derivative Suits

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Some shareholders are using lawsuits as a new tactic to fight what they perceive as an escalation in executive compensation. Shareholders are likely to find these suits difficult to push through the courts on their merits, but the suits can cost subject companies time and money, not to mention reputational harm brought on by negative media attention.

Last year, we saw shareholder derivative suits filed on behalf of [KeyCorp](#) (in Ohio state court) and [Occidental Petroleum](#) (in California state court) in connection with failed say-on-pay votes during the 2010 proxy season. KeyCorp agreed, according to Reuters, to pay \$1.75 million in attorneys' fees and expenses to settle related suits and Occidental Petroleum, faced with three suits, settled one for an undisclosed amount and had two dismissed. Both KeyCorp and Occidental announced significant changes to their executive compensation practices following the shareholder suits.

Similar lawsuits have been filed during the 2011 proxy season. Earlier this month, a shareholder derivative suit [Hercules Offshore, Inc.](#) against the company's directors, named executive officers and compensation consultant. This suit represents the fourth shareholder derivative suit following a failed say-on-pay vote during the 2011 proxy season. Suits have been filed on behalf of [Umpqua Holdings](#) (in Oregon), [Jacobs Engineering Group](#) (in California) and [Beazer Homes USA](#) (in Georgia) – all of which held meetings early in the proxy season.

In the suits on behalf of all six companies, the plaintiffs assert a disconnect between pay and performance, because of weakening corporate financial performance and increasing executive compensation. However, unlike the suits filed in 2010, in which the plaintiffs claimed a multi-year history of excessive compensation at the respective companies, the suits filed this year focus on 2010 compensation relative to company performance.

The suits each claim that the directors breached their fiduciary duties, generally arguing that approving an increase in executive compensation not in line with the company's disclosed pay-for-performance policy was an invalid exercise of the directors' business judgment. The plaintiffs argue that the failed say-on-pay votes rebut the presumption that the directors' acted in the best interests of the company. The validity of this argument is questionable in the case of the 2011 suits in light of the specific Dodd-Frank provision that the say-on-pay votes mandated by the Act do not create or imply any change to or addition to the fiduciary duties of directors.

Even so, if the cases get beyond a motion to dismiss, the outcome may be affected by the record (recall the Disney case from a few years ago). Companies should consider what the background documents will show (including any compensation committee minutes) and be conscious of reviewing the record as closely as in, say, M&A matters.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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