EXECUTIVE PAY DOES NOT NEED ITS DAY IN COURT

I. BACKGROUND 260
A. *Executive Pay Decisions* 261
B. *Communicating Executive Pay* 262
II. SHAREHOLDER PROTECTION AND POWERS 264
A. *Shareholder Protections*. 265
1. Independence 265
2. Disclosure 266
B. *Shareholder Powers* 267
1. Selling 267
2. Voting 268
3. Proxy Access 269
C. *Application* 271
III. THE BUSINESS JUDGMENT RULE 272
A. *Business Judgment*. 272
1. Fiduciary Duties 273
2. Application 274
B. *Demand Futility* 276
C. *Corporate Waste* 277
D. *Application* 279
IV. SAY-ON-PAY LITIGATION 279
A. *The Dodd-Frank Act*. 280
B. *Say-on-Pay Results* 281
C. *Derivative Litigation* 282
D. *Application* 285
V. CONCLUSION 289

Few topics incite as much passion as executive compensation. Executive pay is high, and seems to keep climbing higher. In 2012, the median pay of chief executive officers ("CEOs") at companies in the S&P 500 was $9.7 million, an

increase of 5% over the year before.[1] Also in 2012, CEO pay was 354 times that of the average worker, up from 42 times in 1980.[2] As a result, criticism of executive pay abounds, and few commentators have offered evidence that these levels of pay are justified.[3] However, some commentators have pointed to certain justifications such as external validation.[4]

Whether or not executive pay is justified, one thing is clear: shareholders generally are not happy about it.[5] Investors are increasingly looking for more corporate accountability and more involvement in the process.[6]

In 2010, in response to the financial collapse, this concern was addressed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[7] The Dodd-Frank Act provided for a handful for executive pay and corporate governance reform provisions, including the implementation of a mandatory shareholder vote to approve (or to vote against) compensation practices.[8] Surprising critics of executive pay, shareholders overwhelmingly supported compensation practices at companies in the first year of the vote.[9] More importantly, this vote added another arrow to shareholders' quiver of powers to influence corporate decisions, supplementing the right to sell stock, vote against directors, and sue.[10] Ironically, this non-binding vote, intended to be an efficient medium for shareholder expression, resulted in some shareholders snubbing the powers

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1. *CEO Pay Strategies 2013*, EQUILAR.COM, http:// www.equilar.com/images/pdf/ publications/2013/equilar-2013-ceo-pay-stategies-exec-summary.pdf (last visited Mar. 11, 2014).

2. *Executive Paywatch*, AFL-CIO.ORG, http://www.aflcio.org/Corporate-Watch/ CEO-Pay-and-You/Trends-in-CEO-Pay#1 (last visited Jan. 13, 2013)[hereinafter *Executive Paywatch*]; Lawrence Mishel & Natalie Sabadish, *CEO Pay In 2012 Was Extraordinarily High Relative To Typical Workers And Other High Earners*, ECON. POLICY INST. (June 16, 2013), http://www.epi.org/publication/ceo-pay-2012-extraordinarily-high/.

3. *See, e.g.*, Steven N. Kaplan, *Executive Compensation and Corporate Governance in the U.S.: Perceptions, Facts and Challenges* 2 (Sept. 2012), *available at* http://ssrn.com/ abstract=2134208. The appropriateness of executive pay is not the focus of this paper.

4. James B. Wade et al., *Worth, Words, and the Justification of Executive Pay*, 18 J. ORG. BEHAV. 641, 643-44 (1997) (noting the three types of justifications: external validation, shareholder alignment, and pay for performance).

5. Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 569 (2001).

6. *Id.*

7. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

8. *Id.* § 951, 124 Stat. at 1899.

9. Mark A. Metz, *Say What!? Results of the First Year of Mandatory Say on Pay in the United States and Related Litigation*, 12 J. BUS. & SEC. L. 281, 284 (2012).

10. Thomas & Martin, *supra* note 5, at 569-70.

to sell and vote, and opting instead for litigation based on the result of the vote.[11] While most of the litigation has been unsuccessful, it draws into question the continued viability of the business judgment rule in protecting director decisions in setting executive pay.[12]

This article establishes that the presumption of business judgment balanced against the existing shareholder protections and powers precludes the necessity of the vast majority of executive compensation litigation. The first two sections highlight the executive pay setting background, including the separation of director and shareholder control, and the already existing shareholder protections and powers. The third section discusses the development and continued application of the business judgment rule and related doctrines. The final sections highlight the recent surge of executive compensation litigation and provide guidance on how these claims should be evaluated in the future.

This article focuses on executive compensation issues at large, publicly-traded, domestic corporations registered under the Securities Exchange Act of 1934.[13] This article also focuses on the application of Delaware General Corporation law.[14]

I. BACKGROUND

Executive pay levels and practices are a constant battleground for directors and shareholders.[15] Unfortunately for shareholders, directors hold most of the decision making power.[16] However, this power does not excuse directors from communicating in detail to shareholders how executive pay decisions are made.[17]

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11. Metz, *supra* note 9, at 285. This is perhaps indicative of an increasingly litigious society. Chris M. Amanteas & Belynda B. Reck, *Doing Business in an Increasingly Litigous Society*, HUNTON & WILLIAMS LLP (October 11, 2011), http://www.hunton.com/files/Uploads/Documents/Events/CalCIMA_2011_Paper.pdf.

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

13. *See* 15 U.S.C. § 78*l* (2012); *see also* 15 U.S.C. § 78n (requiring the lawful solicitation of proxies with respect to securities registered pursuant to Section 78*l*).

14. DEL. CODE ANN. tit. 8, §§ 101-398 (West 2012). Delaware's General Corporation Law is widely regarded as the most advanced, and more than half of all U.S. publicly-traded companies and 64% of the Fortune 500 have their legal home in Delaware. Jeffrey W. Bullock, *2012 Annual Report*, DELAWARE DIVISION OF CORPORATIONS (2013), http://corp.delaware.gov/pdfs/2012CorpAR.pdf.

15. Thomas & Martin, *supra* note 5, at 569.

16. DEL. CODE ANN. tit. 8, § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

17. 17 C.F.R. § 229.402 (2011).

A. *Executive Pay Decisions*

Delaware law places the business and affairs of a corporation in the capable hands of the board of directors.[18] This includes the power to appoint executives and determine how, and how much, they will be paid.[19] Delaware courts have determined that this is a broad power.[20] However broad, this power does not eliminate the fiduciary duties owed by directors to the corporation.[21] Conversely, shareholders are not given the power to make executive compensation decisions.[22] As discussed in more detail below, the Dodd-Frank Act's implementation of a mandatory shareholder advisory vote on executive compensation has allowed shareholders a more practical medium for influencing executive compensation decisions.[23] However, this vote is non-binding, and directors are not required to comply with the opinions of shareholders.[24]

This decision making construct is acceptable as directors are more involved in the operations of a corporation, and are better suited to make this type of decision.[25] Generally, compensation decisions are not made by the entire board, but by a designated committee.[26] Practically, large, publicly-traded corporations are required to delegate this decision making process to a

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18. DEL. CODE ANN. tit. 8, § 141(a).

19. *Id.* § 122(5) ("Every corporation created under this chapter shall have power to . . . [a]ppoint such officers and agents as the business of the corporation requires and to pay or otherwise provide for them suitable compensation . . . .").

20. Brehm v. Eisner, 746 A.2d 244, 262 n.56 (Del. 2000) ("To be sure, directors have the power, authority and wide discretion to make decisions on executive compensation.").

21. *See* DEL. CODE ANN. tit. 8, § 141(a); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984). These duties primarily take the form of a duty of care and a duty of loyalty. ROBERT A. RAGAZZO & FRANCES S. FENDLER, CLOSELY HELD BUSINESS ORGANIZATIONS 449 (West 2d ed. 2012). Delaware jurisprudence has also recognized the duty to act in good faith. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 66 n.109 (Del. 2006). These duties do not include a duty to follow ideal corporate governance practices. *Brehm*, 746 A.2d at 256.

22. *See* DEL. CODE ANN. tit. 8, § 122(5). Shareholders do have the ultimate power to sell stock and vote on directors, as well as other means of influence. Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No"*, 67 U. CIN. L. REV. 999, 1017-18 (1999).

23. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1899 (2010).

24. 15 U.S.C. § 78n-1(c) (2012).

25. *See* Thomas & Martin, *supra* note 5, at 602.

26. Minor Myers, *The Perils of Shareholder Voting on Executive Compensation*, 36 DEL. J. CORP. L. 417, 423 (2011). Delaware law empowers a board to designate committees and to delegate to them broad powers and authority. DEL. CODE ANN. tit. 8, § 141(c).

compensation committee comprising independent directors.[27] The compensation committee typically hires an independent compensation consultant to provide data and analysis, and works with the consultant to determine the best course of action.[28] The vast majority of large, publicly-traded domestic corporations follow a similar process for making executive pay decisions that rests the ultimate power in the hands of the committee.[29] The viability of the executive pay decision-making process is not addressed in this article.[30]

B. *Communicating Executive Pay*

All compensation paid to a company's top executive officers must be communicated to shareholders.[31] The Securities and Exchange Commission ("SEC") requires clear, concise, and understandable disclosure of all compensation awarded to, earned by, or paid to the executive officers.[32] This information is included in a company's proxy statement required to be furnished to shareholders prior to a shareholder vote.[33]

This disclosure generally includes a narrative disclosure in the Compensation Discussion and Analysis ("CD&A") section that discusses and analyzes the material factors underlying

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27. 15 U.S.C. § 78j-3(a). The Securities Exchange Act of 1934, as amended by the Dodd-Frank Act, requires the Securities and Exchange Commission to direct the national securities exchanges to prohibit the listing of any issuer without an independent compensation committee. *Id.* Despite any indication to the contrary, similar requirements already existed. *E.g.*, New York Stock Exchange Listed Company Manual § 303A.05(a) (2005) (amended 2010). Additionally, certain tax code provisions allowing for favorable treatment of executive pay require compensation committee independence. *E.g.*, I.R.C. § 162(m)(4)(C)(i) (2012).

28. 15 U.S.C. § 78j-3(b). Delaware law protects directors who rely in good faith on information provided by experts. DEL. CODE ANN. tit. 8, § 141(e).

29. Michael J. Segal et al., *Compensation Committee Guide*, WACHTELL LIPTON ROSEN & KATZ 8 (Jan. 2011), http://www.wlrk.com/webdocs/wlrknew/wlrkmemos/wlrk/wlrk.18330.11.pdf. Ultimately, the committee makes the final decision, but relies on the data, analysis, and advice of the consultant in formulating the appropriate vehicles and amounts of executive pay. *Id.*

30. See Myers, *supra* note 26, at 424-27, for a discussion of this topic.

31. 17 C.F.R. § 229.402 (2011). The disclosure rules apply only to the named executive officers: the principal executive officer (or CEO), the principal financial officer, and the three most highly compensated executives that are not the PEO or PFO. *Id.* at § 229.402(a)(3).

32. *Id.* at § 229.402(a)(2). For more information on the rationale and implementation of the current disclosure rules, see Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,159 (Sept. 8, 2006) (codified at 17 C.F.R. pt. 229); Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,335 (Dec. 23, 2009) (codified at 17 C.F.R. pt. 229).

33. 17 C.F.R. § 240.14a-3. *See also* 15 U.S.C. § 78n-1.

compensation policies and decisions.[34] The narrative is followed by tabular disclosure of the compensation with respect to the prior fiscal year, holdings of equity-related interests, and post-employment compensation.[35] The tabular disclosure includes a Summary Compensation Table showing the total compensation for each named executive officer for the past three years.[36]

The Dodd-Frank Act further added to these requirements by requiring disclosure on compensation consultant conflicts, the relationship between CEO pay and the pay of all other employees, and the relationship between executive pay and company performance.[37] The Act requires the SEC to adopt rules with respect to the foregoing requirements, and as of the writing of this article, the SEC has done so regarding the compensation consultant conflicts.[38] However, the additional disclosure items introduced by the Dodd-Frank Act are wrought with difficulty and have yet to be adopted by the SEC.[39]

The requirement of robust disclosure helps reduce the informational asymmetry between directors and shareholders, allowing shareholders to make informed investment and voting decisions.[40] This informational asymmetry is further reduced by the rise in influence of proxy advisory firms.[41] Proxy advisors such as Institutional Shareholder Services, or ISS, provide shareholders with information and recommendations regarding

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34. 17 C.F.R. § 229.402(b) (2011). This disclosure should include, among other requirements, a discussion of the objectives of the compensation program, what the program is designed to reward, why the board or committee chose to pay each element, how amounts were determined, and how each decision fits into the overall compensation program objective. *Id.*

35. 17 C.F.R. § 229.402(c)–(i).

36. *Id.* § 229.402(c)(1). This requirement includes the reporting of compensation earned in a particular year, whether or not the executive was paid in that year. 17 C.F.R. § 229.402(c)(2)(iii).

37. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951-57, 124 Stat. 1376, 1899-1907 (2010)(codified as amended in scattered sections of 15 U.S.C. 78). The consultant conflict disclosure was a further enhancement of the 2009 SEC requirements. *See* 17 C.F.R. § 229.407 (2011). The Act also implemented mandatory say-on-pay, as discussed below, as well as other governance requirements not discussed in this article. Dodd-Frank Act, §§ 951-57.

38. *See, e.g.*, Listing Standards for Compensation Committees, 77 Fed. Reg. 38,422, 38,423 (June 27, 2012) (codified at 17 C.F.R. pt. 229).

39. *Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act — Pending Action*, SEC.GOV, http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml (last visited Mar. 23, 2014). The pay ratio disclosure is especially troubling and burdensome. *Comments on Proposed Rule Implementing the Pay Ratio Disclosure File Number S7-17-13*, CENTER ON EXECUTIVE COMPENSATION (Dec. 2, 2013), *available at* http://www.execcomp.org/commentary/commentary_payratio. aspx.

40. Myers, *supra* note 26, at 453.

41. *Id.* at 454.

votes on corporate directors and other matters.[42] These firms publish their guidelines for making vote recommendations, allowing shareholders and issuers the opportunity to understand how pay practices will be evaluated.[43] This service allows investors with multiple holdings to outsource the voting decisions to a third party.[44] While the degree of benefit this service provides may be debated, proxy advisory firms play a significant role in providing information to investors, thereby reducing the asymmetry with directors.[45] This service also provides a level of comfort to shareholders that an independent entity is thoroughly reviewing the executive pay practices of the companies in which they own shares.

As a result of robust and transparent disclosure requirements and the substantial influence of proxy advisory firms, shareholders have greater access to information and resources, allowing them greater protection from director abuse, and a greater ability to make decisions with respect to their inherent powers.[46]

II. SHAREHOLDER PROTECTIONS AND POWERS

Shareholders are typically not involved in the pay setting process.[47] However, they are afforded the inherent protections of compensation committee independence and robust disclosure requirements, as discussed above.[48] More importantly, they have the power to affect the process in a variety of ways.[49] Shareholders may influence corporate directors in making executive compensation decisions through selling their stock, voting against directors or other initiatives, or pursuing litigation.[50] This section posits that shareholder protections and

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42. *About ISS*, ISSGOVERNANCE.COM, http://www.issgovernance.com/about (last visited Mar. 23, 2014).

43. *See* INSTITUTIONAL S'HOLDER SERVS., INC., 2014 U.S. PROXY VOTING SUMMARY GUIDELINES (2014) 38-55 [hereinafter ISS GUIDELINES], *available at* http://www.issgovernance.com/files/ISSUSSummaryGuidelines2014March12.pdf.

44. *See id.*

45. Myers, *supra* note 26, at 454. Because proxy advisors must establish guidelines that consider many constituents, it is doubtful they are able to discriminate between good and bad pay arrangements. *Id.*

46. *See* Thompson, *supra* note 22, at 1001 (discussing shareholder powers).

47. *See, e.g.*, Del. Code Ann. tit. 8, § 141 (West 2012)(vesting default authority in board, not shareholders).

48. *See* 15 U.S.C. § 78j-3(a) (2012); 17 C.F.R. § 229.402 (2011).

49. *See* Thompson, *supra* note 22, at 1001.

50. *Id.*

the powers to sell and vote preclude the necessity of the power to sue over executive compensation.[51]

A. *Shareholder Protections*

In evaluating executive pay litigation, courts should first consider two key shareholder protections already in place: compensation committee independence and executive compensation disclosure requirements.[52]

1. Independence

First, for large, publicly-traded companies, executive compensation decisions are required to be made by a committee of independent directors.[53] Independence allows directors to evaluate pay from a disinterested position, and negotiate with executives at arm's-length.[54] This construct eliminates the incentive of directors to set pay at unreasonable levels.[55] Directors, if they are truly independent, are unable to benefit personally from pay decisions and will not be motivated to set high levels of pay absent valid justification.[56] When evaluating executive pay, courts have respected the inherent shareholder protection from self-interested director abuse.[57]

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51. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005) ("The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court."), *aff'd*, 906 A.2d 27 (Del. 2006).

52. *See* 15 U.S.C. § 78j-3(a); 17 C.F.R. § 229.402. Shareholders are also protected by the fundamental fiduciary obligations of directors. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

53. 15 U.S.C. § 78j-3(a).

54. Myers, *supra* note 26, at 424.

55. *See id.* However, some commentators argue that CEOs have considerable power over the board of directors. *See id.* at 425. In fact, some argue that the benefit of independence has been compromised by the CEOs' ability to confer benefits on the independent directors. *Id.* at 425 n.40 (citing Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* 29 (2004)). It is unlikely this is true in the context of large, publicly-traded companies. *See* 17 C.F.R. § 229.402(k) (requiring the disclosure of director compensation); 17 C.F.R. § 229.404 (requiring the disclosure of transactions with related persons).

56. *See* 15 U.S.C. § 78j-3(a). Relevant factors in determining the independence of committee members include: "the source of compensation of a member of the board of directors of an issuer, including any consulting, advisory, or other compensatory fee paid by the issuer to such member of the board of directors" and "whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer." *Id.* *See also* Myers, *supra* note 26, at 424.

57. *See* Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000) ("[D]irectors' decisions will be respected by courts unless the directors are interested or lack independence . . . .").

2. Disclosure

Additionally, courts should acknowledge that shareholders are protected by the requirement of directors to thoroughly disclose the results of the executive compensation decision making process.[58] Because of the significant information asymmetry between directors who make the decisions and shareholders who buy and vote the shares, the importance of robust executive compensation disclosure as a shareholder protection cannot be overstated.[59] Without rules mandating clear and concise disclosures, it is likely shareholders would be left in the dark.[60] The current disclosure requirements go a long way in informing investors on why and how pay-decisions are made, giving shareholders access to the thought process of the committee.[61]

Less information asymmetry reduces the potential for director abuse in the pay setting process.[62] Because every aspect of the executive compensation process is required to be disclosed, it is difficult for directors to "hide" anything from shareholders.[63] Directors are held accountable for their actions by way of being forced to confess their "sins" to the public.[64] Every instance of bad faith, gross negligence, or self-interest is essentially brought to the surface, or else the disclosure rules have been disregarded as well.[65]

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58. *See* 17 C.F.R. § 229.402.

59. Myers, *supra* note 26, at 452-53. Shareholders are not present at compensation committee meetings, and therefore must rely on the information communicated to them by the committee. *See id.* at 453.

60. *See* JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION 39-40 (Foundation Press 12th ed. 2012). Most companies would likely not be as robust in their disclosure if not required to be. *Id.* However, some may weigh the burden of excessive disclosure against the benefit of greater transparency reducing risk and resulting in a lower cost of capital. *Id.*

61. *See* Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334 (Dec. 23, 2009) (codified at 17 C.F.R. pt. 229) ("The disclosure enhancements . . . will significantly improve the information companies provide to shareholders . . . ."). *See also* 17 C.F.R. § 229.402(b) ("The discussion shall describe . . . [w]hy the registrant chooses to pay each element [and] [h]ow the registrant determines the amount (and, where applicable, the formula) for each element to pay . . . .").

62. *See* Myers, *supra* note 26, at 452-53.

63. *See id.* at 453.

64. *See* 17 C.F.R. § 229.402.

65. *See id.* § 240.14a-9. It is unlawful to solicit by any means of communication any proxy containing any statement that is "false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading." *Id.* An implied private right of action exists under this rule, providing shareholders protection from fraudulent disclosure. J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

Further, the obligation to disclose why a pay-decision was made requires directors to provide at least some justification for what may be seen as high levels of pay, reducing the possibility that directors will set pay at a high level arbitrarily.[66] This also requires directors to disclose the inputs used in the decision making process, reducing the possibility that directors will make uniformed decisions.[67]

Related to the shareholder protection of disclosure is the force of proxy advisory firms.[68] These firms exist to protect shareholders through the further reduction of information asymmetry.[69] Whether or not shareholders are able to evaluate compensation disclosures for themselves, firms like ISS provide recommendations based on those disclosures, affording shareholders an extra layer of protection from director abuse.[70]

When evaluating challenges to executive compensation decisions, courts should first consider the significant protections provided to shareholders through compensation committee independence and executive compensation disclosures.[71]

B. *Shareholder Powers*

Courts should also consider the powers of shareholder to impact the decision making process. The shareholder ability to sell stock and vote against directors provides significant power in influencing disagreeable compensation practices.[72] If shareholders are unhappy, they may walk away.[73] If shareholders are displeased with a director, they may vote against that director's reelection.[74]

1. Selling

A shareholder's ultimate power resides in the power to sell the company stock and take their capital elsewhere.[75] The

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66. *See* 17 C.F.R. § 229.402(b).

67. *Id.* However, it is not necessarily required that directors disclose every alternative considered in the process. *See* Myers, *supra* note 26, at 453. As a result, informational asymmetry may still exist; however, it is likely too insignificant to allow for director abuse. *See id.*

68. *Id.* at 454.

69. *See generally*, ISS GUIDELINES, *supra* note 43, at 28-49.

70. *See* Myers, *supra* note 26, at 454. However, because they have access to the same information, sophisticated investors may benefit little from this service. *Id.*

71. *See id.* at 424, 453.

72. Thompson, *supra* note 22, at 1001.

73. *Id.* at 1002.

74. *Id.* at 1001; *see* DEL. CODE ANN. tit. 8, § 212 (West 2012).

75. Thompson, *supra* note 22, at 1002.

impact of selling may be limited on an individual level, but not necessarily at the institutional level.[76] The argument can be summarized as: if shareholders sell, or refuse to buy, the stock of those companies with disagreeable pay practices, then those companies would be forced to change their practices in order to raise future equity capital.[77] To sell, shareholders would likely require the ability to purchase a similar asset with similar risks and returns, but with better executive pay practices.[78]

Of course, it is impractical that individual shareholders could have a dramatic effect on corporate pay practices; for companies to be materially affected, a large number of shares would have to be sold.[79] But the ultimate power of shareholders to voice their dissatisfaction by selling and walking away remains.[80] This power alone precludes the need to bring executive compensation into court.[81] If shareholders don't like the how the company pays its executives, they should sell the company's stock.

2. Voting

Shareholders may influence pay decisions in a more direct way through exercising their voting rights.[82] The primary focus of this section is the ability of shareholders to elect and remove directors.[83] Prior to the implementation of say-on-pay, the ability to withhold[84] votes from directors was the focus of shareholder power as it relates to pay decisions.[85] The practical effect of this power is that directors must consider their own jobs in making

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76. *See* COFFEE & SALE, *supra* note 60, at 39-40. Due to the rise of the institutional investor, stock ownership has become concentrated and collective action is more feasible. *Id.*

77. *See* Susan Lorde Martin, *The Executive Compensation Problem*, 98 DICK. L. REV. 237, 239 (1994).

78. *See id.*

79. *See* COFFEE & SALE, *supra* note 60, at 39-40.

80. Thompson, *supra* note 22, at 1002. *But see* Martin, *supra* note 77, at 239 (discussing the "Wall Street Rule" and its lack of practical application).

81. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

82. DEL. CODE ANN. tit. 8, § 212 (West 2012).

83. *Id.* § 211(b). *But see id.* § 141(k) (limiting the removal of directors in certain situations). The non-binding say-on-pay vote implemented by the Dodd-Frank Act is discussed below.

84. *See id.* § 216(3). Generally, companies using a plurality voting standard, as opposed to a majority standard, use "withhold" as the contrary vote option in director elections. *See id.*

85. ISS GUIDELINES, *supra* note 43, at 38-39 (recommending votes be withheld from directors in situations of poor executive pay practices).

executive compensation decisions.[86] While directors have broad discretion in setting executive pay, this discretion is tempered by the dynamic of appointment.[87] Displeased shareholders may readily withhold votes from current directors, or elect new directors.[88] Shareholders are unable to control executive pay, but they are able to control the directors who determine it.[89]

This power is also impacted by the impressive rise in force of proxy advisory firms.[90] Because many institutional investors rely on these firms for how to vote at annual meetings, proxy advisors' influence over the voting process is significant.[91] Although this is a benefit to investors with limited time to review extensive proxy disclosures, the benefit may not always be worth the cost.[92] In fact, this service may do little more than funnel the voting power of shareholders through a handful of organizations.[93]

Substantial reliance on proxy advisors' voting recommendations is likely to result in the voting power being transferred from sahreholders to these firms.[94] Effectively, this weakens the ability of shareholders to express their own dissatisfaction with directors, and allows firms like ISS to express their views instead.[95] As a result, it is the agenda of proxy advisors that often prevails, not that of shareholders.[96] However, shareholders still control the power to vote for or against directors, despite the influence of proxy advisory firms.[97]

3. Proxy Access

86. *See id.* at 38.

87. *See* Brehm v. Eisner, 746 A.2d 244, 262 n.56 (Del. 2000).

88. Thompson, *supra* note 22, at 1001. This power is not without limitation. DEL. CODE ANN. tit. 8, § 141(k) (West 2012). Classified boards and a lack of resources to put a new director on the ballot are bars to the full exercise of shareholder control. Thompson, *supra* note 22, at 1001.

89. *See* DEL. CODE ANN. tit. 8, § 211(b) (West 2012).

90. Myers, *supra* note 26, at 454.

91. *Id.* Some compensation committees may go as far as to tailor executive pay practices to follow the ISS Guidelines. *See* Segal et al., *supra* note 29, at 52.

92. *See* Myers, *supra* note 26, at 454-55. These firms evaluate the same disclosure available to investors, and are increasingly formulaic in their approach to recommendations. *Id.* The ability to evaluate what is best for shareholders of each company in each industry in each size range is impractical, and not attempted. *Id.*

93. See *id.*

94. *See id.*

95. *See* Segal et al., *supra* note 29, at 49-50.

96. *See id.*

97. DEL. CODE ANN. tit. 8, § 212 (West 2012).

While the ability to vote against directors is a significant power possessed by shareholders, the ability to efficiently nominate their own candidates onto the director election ballot may be more valuable.[98] This ability, termed "proxy access," has eluded shareholders for decades.[99] After failed attempts to implement proxy access in 2003, 2007, and 2009, the Dodd-Frank Act finally gave the SEC the authority to introduce rules to facilitate the ability of shareholders to nominate directors.[100] However, this authority has since been quashed.[101]

Pursuant to the Dodd-Frank Act, the SEC in 2010 adopted a rule requiring companies to include shareholders' director nominees in company proxy materials (mandatory proxy access rule), and amended a rule permitting shareholders to require companies to include shareholder proposals regarding proxy access procedures in company proxy materials (shareholder proposal rule).[102] The mandatory proxy access rule was challenged in litigation, and the SEC stayed the effective date of both rules.[103] In 2011, the D.C. Circuit court held that the SEC's rulemaking was arbitrary and capricious in promulgating the mandatory proxy access rule.[104] The SEC decided not to challenge the decision on the mandatory proxy access rule, and allowed the stay to lapse on the shareholder proposal rule.[105]

While proxy access is not mandatory, companies may voluntarily allow shareholders access to company proxy solicitation materials.[106] Additionally, certain shareholders may still submit a proposal requiring directors to adopt proxy access

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98. *See* Myers, *supra* note 26, at 427 (noting how the ability of shareholders to nominate directors with ease and with reimbursement from the corporation increases shareholder power). To be sure, shareholders maintain the ability to nominate their own directors for election, but are generally limited to using their own resources and without access to the company's proxy materials. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,670 (Sept. 16, 2010). This process is costly, inefficient, and practically ineffective. *Id.*

99. For a full discussion of the history of proxy access reform, see Evan M. Epstein et al., *SEC Proxy Access Reform Key Positions and Potential Outcomes*, ROCK CENTER FOR CORPORATE GOVERNANCE (Apr. 21, 2010), http://rockcenter.law.stanford.edu/wp-content/uploads/2010/05/Stanford-Rock-Center-Proxy-Access-Reform-Paper_1.pdf?9d7bd4.

100. *Id.* at 4-5; *see* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010).

101. Bus. Roundtable v. SEC, 647 F.3d 1144, 1156 (D.C. Cir. 2011) (vacating the SEC's proxy access rule).

102. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,668 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

103. *Bus. Roundtable*, 647 F.3d at 1148.

104. *Id.* at 1156.

105. *Statement by SEC Chairman Mary L. Shapiro on Proxy Access Litigation*, SEC.GOV (Sept. 6, 2011), http://www.sec.gov/news/press/2011/2011-179.htm.

106. DEL. CODE ANN. tit. 8, § 112 (West 2012).

provisions.[107] A successful proposal would result in the company allowing shareholders access to company resources to nominate a director candidate.[108] With proxy access, not only would a shareholder be able to vote against a current director, she would also be able to nominate her own choice of director to take the removed director's place.[109] This ability provides shareholders an additional power in voicing dissatisfaction with executive pay practices, although on a limited basis.[110]

C. *Application*

Courts should give considerable weight to the protections and powers of shareholders when determining whether a challenge to executive compensation has merit. Despite the lack of control in the decision making process,[111] shareholders are inherently protected from director abuse[112] and are equipped with powers to influence the decision making process.[113] With these safeguards, the potential for bad faith decision making is limited, and the need to resort to litigation is significantly reduced.[114] As a result, courts should be cautious in evaluating the decision to challenge executive pay through litigation.[115] As discussed below, this is aligned with sound policy.[116]

Delaware law has established rules that place a large burden on stockholders who "believe they should pursue the remedy of a derivative suit instead of selling their stock or seeking to reform or oust these directors from office."[117] Shareholders who fail to act responsibly and instead rely on litigation to address dissatisfaction with executive pay should not receive the benefit of judicial review.[118]

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107. 17 C.F.R. § 240.14a-8 (2011).

108. *See* 75 Fed. Reg. 56,691 (Sept. 16, 2010).

109. *See id.* As of May 2012, a number of proposals have been submitted by shareholders, but none have received significant support. *Proxy Access Proposals Filed for the 2012 U.S. Proxy Season*, ISS GOVERNANCE (May 10, 2012), http://www.issgovernance.com/files/private/AccessProposals051112.pdf.

110. *See* Myers, *supra* note 26, at 427.

111. DEL. CODE ANN. tit. 8, § 141(a) (West 2012); *see id.* § 122(5). Directors control the broad power and authority to determine executive compensation. *See* Brehm v. Eisner, 746 A.2d 244, 262 n.56 (Del. 2000).

112. *See In re* ALH Holdings LLC., 675 F. Supp. 2d 462, 477 (D. Del. 2009).

113. *See* Thompson, *supra* note 22, at 1001.

114. *See generally* Thomas & Martin, *supra* note 5, at 602.

115. *See id.*

116. *See* Brehm v. Eisner, 746 A.2d 244, 267 (Del. 2000).

117. *Id.*

118. *See id.*

As discussed in the next section, the business judgment rule directs courts to respect director decisions regarding executive compensation.[119] Where disinterested directors make informed decisions in good faith and in the best interest of the company, shareholder dissatisfaction should not be reviewed in court.[120] The shareholder protections and powers combined with the presumption of business judgment, absent a showing of bad faith, direct courts to dismiss litigation arising out of dissatisfaction with executive compensation.[121]

III. THE BUSINESS JUDGMENT RULE

The business judgment rule is a doctrine developed in corporate law that protects directors from liability when acting in the ordinary course of their duties.[122] The rule is an "acknowledgment of the managerial prerogatives of Delaware directors."[123] Delaware law places the affairs of the corporation in the hands of the board of directors, and the business judgment rule protects their decisions.[124] As discussed below, this protection from liability is intertwined with the doctrines of demand futility and corporate waste.[125]

A. *Business Judgment*

The business judgment rule has been formulated by Delaware courts as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[126] The presumption can be rebutted on a showing that the directors breached their fiduciary duties or conducted their business activities in bad faith.[127] Under this doctrine, courts will respect the decisions of directors if they were disinterested, used a rational process and availed

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119. *Brehm*, 746 A.2d at 264 n.66.

120. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006).

121. *Id.*

122. D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation*, 81 TUL. L. REV. 829, 831-32 (2007).

123. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

124. DEL. CODE ANN. tit. 8, § 141(a) (West 2012); *Aronson*, 473 A.2d at 812.

125. *Aronson*, 473 A.2d at 812 ("It comes into play in several ways—in addressing a demand, [and] in the determination of demand futility . . . ."); *see In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 73-74 (Del. 2006) (reciting the doctrine that "a plaintiff who fails to rebut the business judgment rule presumptions is not entitled to any remedy unless the transaction constitutes waste").

126. *Aronson*, 473 A.2d at 812.

127. *Disney*, 906 A.2d at 52.

themselves of all reasonably available material information, and acted in good faith.[128] This section explores this presumption further.

1. Fiduciary Duties

Delaware courts have generally recognized two primary fiduciary duties of directors: the duty of loyalty and the duty of care.[129] The same courts have also recognized a third primary fiduciary duty: the duty to act in good faith.[130] However, the duty to act in good faith is not a well-developed area of corporate fiduciary law.[131] Despite the lack of development, this duty plays a prominent role in the evaluation of the presumption of business judgment.[132]

The fiduciary duty of loyalty is classically defined as the preference of the interest of the corporation over the adverse self-interest of the fiduciary or of a related person.[133] In reviewing director decisions under the presumption of business judgment, the duty of loyalty is often used interchangeably with the concept of disinterestedness.[134] Interestedness is equated to self-dealing: an interested director is one that engages in self-dealing to derive from a transaction a benefit not available to the corporation or shareholders generally.[135]

The duty to act with due care has generally been evaluated as a procedural duty.[136] It has been used interchangeably with

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128. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 124 (Del. Ch. 2009). Or as stated by the Delaware Supreme Court, "directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by grossly negligent process that includes the failure to consider all material facts reasonably available." Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000).

129. *Disney*, 906 A.2d at 52.

130. *E.g.*, Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) ("The directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith."). *But see Citigroup*, 964 A.2d at 122-23 (reciting that good faith "was embedded in the fiduciary duty of loyalty and did not constitute a freestanding fiduciary duty") (citing Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006)).

131. The *Disney* court went to painstaking lengths to define the standard for bad faith in order to provide "some conceptual guidance to the corporate community." *Disney*, 906 A.2d at 63-64.

132. *Id.* at 52.

133. *Id.* at 66.

134. *Compare* Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000), *with Disney*, 906 A.2d at 52.

135. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

136. *See In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 122 (Del. Ch. 2009).

the concepts of employing a rational process and being materially informed.[137] Prior to making a business decision, directors are required to inform themselves of all material information reasonably available.[138] Along with being informed, directors must employ a rational process.[139] This standard of care is "measured by concepts of gross negligence."[140] It has been equated with fraud, bad faith, and an abuse of discretion.[141]

Taken together, the fiduciary duties to act loyally, with due care, and in good faith, support the presumption of business judgment.[142] Generally, a plaintiff must show that directors breached one of these duties to rebut it.[143]

2. Application

"It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second guess a board's decision . . . ."[144] The rule exists to protect director decisions, made in the best interest of the corporation, that subsequently become unpopular with shareholders.[145] Practically, all executive compensation decisions (that do not decrease pay) are unpopular to some shareholders.[146] Courts should not allow unpopularity to result in liability, and should dismiss challenges to executive compensation decisions resulting from shareholder dissatisfaction.[147] Therefore, courts should reserve the review of executive compensation decisions to situations where directors

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137. *Compare Citigroup*, 964 A.2d at 122 (contending that courts would not second guess director action if they employed a rational process and considered all of the relevant material available), *with Disney*, 906 A.2d at 52 (asserting that the law assumes directors make decisions in good faith based on the information available).

138. *Aronson*, 473 A.2d at 812. However, directors are not required to be informed of every fact, only to be reasonably informed. *Brehm*, 746 A.2d at 260.

139. *Citigroup*, 964 A.2d at 122.

140. *Id. But see* Aronson, 473 A.2d at 812 n.6 (indicating that the standard of care is not precisely articulated by Delaware courts, but is held to be a standard less exacting than simple negligence).

141. *Id.* (listing cases attempting to articulate the standard by which the exercise of business judgment is governed).

142. *Disney*, 906 A.2d at 52.

143. *Id.*

144. Brehm v. Eisner, 746 A.2d 244, 260 (Del. 2000).

145. *Id.*

146. *E.g.*, *Executive Paywatch*, *supra* note 2. However, this contingent may be small in number. *See* Metz, *supra* note 9, at 284 (noting that shareholders showed overwhelming support for executive compensation programs at the vast majority of companies during the first two years of say-on-pay).

147. *See Brehm*, 746 A.2d at 266 ("[M]ere disagreement cannot serve as grounds for imposing liability based on alleged breaches of fiduciary duty and waste.").

have breached their fiduciary duties of loyalty, care, or good faith.[148]

Courts and commentators have used many concepts to articulate when the presumption of business judgment is rebutted.[149] However, these concepts may be summarized to permit judicial review of executive compensation decisions only where plaintiffs are able to show a breach of a fiduciary duty.[150] If directors act with self-interest, or otherwise act not in the best interest of the corporation, then they have breached the fiduciary duty of loyalty.[151] If they make uninformed decisions or fail to employ a rational process, or otherwise act in a manner that is grossly negligent, then they have breached their fiduciary duty of care.[152] If directors act with intent to do harm, or with an intentional dereliction of their duties, then they have breached the duty of good faith.[153] These duties may overlap, as the duty of good faith often subsumes the concepts of the other duties.[154]

Generally, the requirement of independent compensation committees and exhaustive disclosure should limit the ability of plaintiffs to successfully show directors breached the fiduciary duties of loyalty and care.[155] This is because director independence limits the ability of plaintiffs to allege facts showing director interestedness in executive pay decisions.[156] Additionally, disclosure of the decision-making process, including inputs and rationale, limits the ability of plaintiffs to allege facts showing directors were uninformed or failed to use a rational process.[157]

As a result, courts should limit their review of executive pay decisions to cases where plaintiffs are able to show that directors acted in bad faith.[158] However, derivative action pleading requirements create a high hurdle for plaintiffs alleging bad

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148. *See Disney*, 906 A.2d at 52.

149. *E.g.*, Telman, *supra* note 122, at 840 (noting judicial review is permitted in "limited cases involving fraud, self-dealing, or decisions so egregious they can only be characterized as waste").

150. *Disney*, 906 A.2d at 52.

151. *Id.* at 66.

152. *See Brehm*, 746 A.2d at 260.

153. *See Disney*, 906 A.2d at 62.

154. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). For example, courts may view a fraudulent act as a breach of the duty of loyalty, but it is surely a breach of the duty of good faith. *See id.*

155. *Id.*

156. *See Brehm*, 746 A.2d at 258.

157. *See id.* at 260.

158. *See* Telman, *supra* note 122, at 840.

faith.[159] Consequently, judicial review is likely to be limited to cases where plaintiffs can show evidence of waste.[160]

B. *Demand Futility*

The doctrine of demand futility is inextricably bound to issues of business judgment.[161] Demand futility is the doctrine that excuses the pre-suit demand requirement of shareholder derivative suits.[162] It rests on the acknowledgment of director control of corporate affairs.[163]

Shareholders bringing a derivative action must make a pre-suit demand on the board or plead particularized facts demonstrating legal excuse from the requirement.[164] Delaware courts have developed a two-prong standard for demand excuse, known as the *Aronson* test.[165] Under this test, demand may be excused if the particularized facts allege a reasonable doubt that either (a) a majority of the board is disinterested and independent for purposes of responding to the demand, or (b) the underlying action was otherwise the product of valid business judgment.[166] However, demand futility is subject to stringent pleading requirements, and is a high barrier to successful shareholder litigation.[167] This barrier aligns well with the established policy of protecting the business decisions of directors.[168]

Delaware law places control of the corporation in the hands of the board of directors, not the shareholders; the strict pre-suit demand requirements stem from this structure.[169] This

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159. *See* Thomas & Martin, *supra* note 5, at 571-72.

160. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 73-74 (Del. 2006).

161. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

162. DEL. CH. CT. R. 23.1(a) ("In a derivative action brought by one or more shareholders or members to enforce a right of a corporation . . . the corporation or association having failed to enforce a right which may properly be asserted by it . . . [t]he complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.").

163. *See Aronson*, 473 A.2d at 812.

164. DEL. CH. CT. R. 23.1(a).

165. Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).

166. *Aronson*, 473 A.2d at 814. Demand futility requires an inquiry into the independence and disinterestedness of directors, as well as the fiduciary duties of directors. *Id.* Similar to the business judgment rule, demand futility creates a presumption that directors did not breach their fiduciary duties in making business decisions. *Brehm*, 746 A.2d at 256.

167. Thomas & Martin, *supra* note 5, at 571-72.

168. *Brehm*, 746 A.2d at 255 (quoting Grimes v. Donald, 673 A.2d 1207, 1217 (Del. 1996)) (noting that the demand requirement creates a balanced environment).

169. DEL. CODE ANN. tit. 8, § 141(a) (West 2012).

responsibility "carries with it certain fundamental fiduciary obligations to the corporation and its shareholders."[170] If shareholders sense a fiduciary duty has been breached, they control the legal right to challenge director actions through a derivative suit.[171] These suits, by their nature, encroach upon director discretion.[172] The pre-suit demand requirement exists to protect the broad discretion afforded to directors.[173] The demand requirement ensures that a shareholder exhausts her intracorporate remedies and protects against strike suits.[174] "Thus, by promoting this form of alternate dispute resolution, rather than immediate recourse to litigation, the demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of the corporation."[175]

The second prong of the *Aronson* test highlights the interaction between the business judgment rule and demand futility.[176] It is under this prong that Delaware courts usually evaluate demand futility in derivative suits that challenge executive pay.[177] This evaluation requires courts to determine whether or not plaintiff shareholders have alleged facts creating a reasonable doubt that directors' decisions are protected under the business judgment rule.[178]

C. *Corporate Waste*

The business judgment rule also plays a prominent role in the doctrine of corporate waste.[179] In the modern era, executive compensation challenges often come in the form of waste claims but are rarely successful.[180] The waste doctrine essentially prohibits "an exchange that is so one sided that no business

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170. *Aronson*, 473 A.2d at 811 (citing Loft, Inc. v. Guth, 2 A.2d 225, 238 (Del. Ch. 1938)).

171. *Id.* ("The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid or unfaithful management."). A derivative action is a suit by shareholders to compel the corporation to sue. *Id.*

172. *Id.*

173. *Id.* at 811-12; *see also* DEL. CH. CT. R. 23.1(a).

174. *Aronson*, 473 A.2d at 811-12. A strike suit is "[a] suit (esp. a derivative action), often based on no valid claim, brought either for nuisance value or as leverage to obtain a favorable or inflated settlement." BLACK'S LAW DICTIONARY 689 (3d pocket ed. 2006).

175. *Aronson*, 473 A.2d at 812.

176. *Id.*

177. *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 258 (Del. 2000) (applying the second prong of the *Aronson* test in its analysis of a challenge to executive pay).

178. *Id.*; *see also Aronson*, 473 A.2d at 812.

179. *See Brehm*, 746 A.2d at 263.

180. RAGAZZO & FENDLER, *supra* note 21, at 546. *But see* Thomas & Martin, *supra* note 6, at 571 ("The well-tested claims of breach of duty of care, breach of duty of loyalty, and waste, are available when the appropriate facts support them.").

person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[181] This doctrine balances against the ability of directors to determine if executives deserve to be paid substantial sums of money.[182]

Delaware courts have developed a stringent standard for waste:[183]

> The judicial standard for determination of corporate waste is well developed. Roughly, a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade. Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift. If, however, there is *any substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude ex post that the transaction was unreasonably risky.[184]

Despite this high standard, there are outer limits.[185] These outer limits are not often found,[186] even in close cases that push the envelope of judicial respect.[187]

The concept of irrationality highlights the interaction between the business judgment rule and the corporate waste doctrine.[188] Irrationality is the functional equivalent of waste, and lies at the outer limit of business judgment.[189] Therefore, an irrational decision is not protected under the business judgment

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181. *Brehm*, 746 A.2d at 263 (quoting *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 362 (Del. Ch. 1998)); *see also* John W. Murrey, III, *Excessive Compensation in Publicly Held Corporations: Is the Doctrine of Waste Still Applicable?*, 108 W. VA. L. REV. 433, 447 (2005).

182. Murrey, *supra* note 181, at 447.

183. RAGAZZO & FENDLER, *supra* note 21, at 546.

184. *Brehm*, 746 A.2d at 263 (quoting Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997)).

185. *Id.* These limits are confined to the concepts of unconscionability and irrationality. *Id.* Irrationality is explained in more detail below.

186. *See* RAGAZZO & FENDLER, *supra* note 21, at 546 (noting that waste claims are rarely successful); Murrey, *supra* note 181, at 436 (noting that in only a few cases has the doctrine of waste been successfully applied).

187. *Brehm*, 746 A.2d at 249.

188. *Id.* at 264.

189. *Id.* (explaining that irrationality is the outer limit of the business judgment rule, and that it may be either the functional equivalent of waste, or used to negate the good faith requirement of the business judgment rule).

rule.[190] If a plaintiff fails to rebut the presumption of business judgment, she may then look to irrationality, or the doctrine of waste.[191] In fact, if the presumption is not rebutted, she "is not entitled to any remedy unless the transaction constitutes waste."[192]

D. *Application*

Courts have applied the doctrines of business judgment, demand futility, and corporate waste together in a manner that places a large, though not insurmountable, burden on shareholders attempting to bring a claim challenging director executive compensation decisions.[193] Used together, the doctrines require plaintiffs to plead particularized facts showing directors breached their fiduciary duties in determining executive pay, or that the determination resulted in waste.[194] Judicial review is effectively limited to cases where directors acted in bad faith or the decision constituted waste.[195] If applying these doctrines correctly and consistently, courts will likely dismiss the vast majority of shareholder litigation over executive pay.[196]

IV. SAY-ON-PAY LITIGATION

In 2011 and 2012, litigation arising out of dissatisfaction with executive pay practices increased significantly.[197] These suits, in large part, were a response to an adverse shareholder vote on executive compensation, and typically were structured as derivative actions alleging a breach of directors' fiduciary duties.[198] The shareholder votes on executive compensation are a result of the implementation of mandatory say-on-pay under the

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190. *Id.*

191. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 73-74 (Del. 2006). The business judgment rule is generally a defense to breach of fiduciary duty claims, not waste claims. *See* Murrey, *supra* note 181, at 457. However, despite precedent to the contrary, it has been applied to defend waste claims. Thomas & Martin, *supra* note 5, at 573.

192. *See Disney*, 906 A.2d at 73-74.

193. *Brehm*, 746 A.2d at 267.

194. *Id.*

195. *See id.* at 264. If shareholders are unable to show that directors breached a fiduciary duty, then recovery is limited to the ability to show the decision constituted waste, or the functional equivalent, that the decision was irrational. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 73-74 (Del. 2006). However, an irrational decision may also be a breach of the duty of good faith. *Brehm*, 746 A.2d at 264.

196. *See Brehm*, 746 A.2d at 267.

197. Metz, *supra* note 9, at 285.

198. *Id.* at 284.

Dodd-Frank Act.[199] As discussed below, these suits are without merit, and should be systematically rejected by courts.[200]

A. *The Dodd-Frank Act*

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was passed in response to what many believe to be the greatest financial crisis since the Great Depression.[201] The Act included numerous provisions related to the oversight of the financial industry and public corporations.[202] Included in these provisions are measures intended to improve practices of corporate governance, accountability, and executive compensation.[203] Among these measures, the Act requires almost all publicly traded companies in the United States to hold an annual shareholder vote on the company's executive compensation practices as disclosed in its annual proxy statement at least once every three years.[204] This vote is often referred to as "say-on-pay."[205] The vote is non-binding on the issuer, and may not be construed to create an additional, or modify an existing, fiduciary duty of the board of directors.[206] The vote became effective for companies holding annual shareholder meetings on or after January 21, 2011.[207]

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199. 15 U.S.C. § 78n-1 (2012).

200. *See* Jacqueline Benson, *Four Emerging Trends in Securities Litigation*, ASPATORE, May 2012, at *4, *available at* 2012 WL 1197182.

201. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951-57, 124 Stat. 1376, 1899-1907 (2010)(codified as amended in scattered sections of 15 U.S.C. 78).

202. *Id.*

203. *Id.* at §§ 951-57, 971-72.

204. 15 U.S.C. § 78n-1 (2012).

205. Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010-11 (adopted Jan. 25, 2011) (codified at 17 C.F.R. pts. 229, 240).

206. 15 U.S.C. § 78n-1(c) (2012) ("The shareholder vote . . . 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 . . . . ").

207. *Id.* § 78n-1(a)(3). The portions of the Act relevant to this article amend the Securities Exchange Act of 1934, requiring rulemaking by the SEC. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899-1900 (2010). The SEC adopted final rules for say-on-pay on January 25, 2011. Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. at 6010.

B. *Say-on-Pay Results: 2011-2012*

The Dodd-Frank Act ushered in the first year of mandatory say-on-pay in the United States.[208] In the first year, the vast majority of companies required to hold say-on-pay votes received overwhelming shareholder support for their executive compensation practices, receiving more than ninety percent support on average at Russell 3000 companies.[209] In the first year, more than ninety-eight percent of companies received majority support for their say-on-pay proposal.[210] In 2012, the second year, that number was just under ninety-eight percent.[211] In the first two years of mandatory say-on-pay, ninety-six percent of Russell 3000 companies received majority support for both years.[212] Although shareholder support was substantial, roughly thirty-eight companies in the first year,[213] and fifty-three in the second year,[214] failed to obtain majority support for their executive compensation practices.[215]

As discussed above, shareholders have a variety of ways to express their dissatisfaction with a company's board of directors.[216] The implementation of mandatory say-on-pay allows shareholders the ability to efficiently communicate to directors and officers their dissatisfaction with executive compensation practices through a non-binding annual vote.[217] However, even after voting against the say-on-pay proposal, some shareholders are not satisfied with this expression of dissatisfaction.[218] With a variety of options in front of them,[219] shareholders at a handful of

208. Metz, *supra* note 9, at 283.

209. TED ALLEN ET AL., INSTITUTIONAL SHAREHOLDER SERVICES INC., 2011 U.S. POSTSEASON REPORT 4 (2011) [hereinafter ISS REPORT]. The Russell 3000 is a commonly-used index due to its inclusion of approximately 98% of the investable U.S. equity market. RUSSELL INVESTMENTS, http://www.russell.com/indexes/PDF/fact_sheets/US/3000.pdf (last visited Jan. 1, 2013).

210. SEMLER BROSSY CONSULTING GROUP, LLC, 2012 SAY ON PAY RESULTS: RUSSELL 3000, at 6 (2012) [hereinafter SEMLER BROSSY REPORT], *available at* http://www.semlerbrossy.com/wp-content/uploads/2012/09/SBCG-SOP-2012-09-05.pdf.

211. *Id.* at 1.

212. *Id.* at 6.

213. ISS REPORT, *supra* note 209, at 1.

214. SEMLER BROSSY REPORT, *supra* note 210, at 2. The Semler Brossy Report notes that it does not reflect a constant sample as a result of Russell 3000 turnover and timing. *Id.* According to the report, the second year failures included four companies that failed in the first year, and forty-eight that passed in the first year. *Id.* at 6.

215. This is commonly referred to as a "failed vote." *Id.*

216. *See* Thomas & Martin, *supra* note 5, at 569–70; *see also* Metz, *supra* note 9, at 284–85.

217. Metz, *supra* note 9, at 284; *see* 15 U.S.C. § 78n-1 (2012).

218. Benson, *supra* note 200, at *1.

219. Thomas & Martin, *supra* note 5, at 569.

companies that failed to obtain majority support chose to pursue litigation.[220] By the end of 2012, derivative lawsuits had been filed against the directors and officers of approximately twenty issuers.[221] These lawsuits have been largely unsuccessful.[222] However, one case in the Southern District of Ohio withstood a motion to dismiss, and simultaneously turned executive pay jurisprudence on its head.[223]

C. *Derivative Litigation*

The majority of suits following a failed say-on-pay vote are similarly structured derivative actions.[224] Most allege that directors breached their fiduciary duties of loyalty and care to the company in approving excessive executive pay and in recommending that shareholders vote in favor of approving the excessive pay (pursuant to say-on-pay).[225] Many include claims that directors failed to act in the best interests of shareholders by not rescinding or modifying the challenged payments following the failed vote.[226] A number of complaints have also included claims against the board's consultant for aiding and abetting in the board's breach of its fiduciary duties, as well as claims against executive officers for unjust enrichment.[227]

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220. Metz, *supra* note 9, at 285. It should be noted that the implementation of a non-binding advisory vote does not create a private cause of action. *See* 15 U.S.C. § 78n-1.

221. *Failed Say on Pay Litigation—Digest of Cases*, EXECUTIVE PAY AND LOYALTY, http://www.executiveloyalty.org/XC_LIT_SOP_Digest.html (last visited Jan. 11, 2013) [hereinafter *Failed Say on Pay Litigation—Digest of Cases*]. A handful of these suits have resulted in settlements, some have been dismissed at the pleadings stage, one has survived a motion to dismiss, and others remain pending. *Id.*

222. Benson, *supra* note 200, at *3.

223. *See* NECA–IBEW Pension Fund *ex rel.* Cincinnati Bell, Inc. v. Cox (*Cincinnati Bell*), No.1:11-cv-451, 2011 WL 4383368, at *5 (S.D. Ohio Sept. 20, 2011).

224. Metz, *supra* note 9, at 286 (discussing in further detail the structure of and allegations in the shareholder complaints). Most of these cases have been filed out of Delaware state courts; however, due to incorporation in Delaware, Delaware law is applied in a number of cases. *See* Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy (*Beazer Homes*), No. 2011–cv-197841, 2011 WL 4836230, at 3 (Ga. Super. Ct. Sept. 16, 2011).

225. Benson, *supra* note 200, at *2. While the facts of each case differ, this article focuses on the general concept of setting executive pay as protected by the business judgment rule. The claimants' notion of excessive pay is generally premised on the failure of the board to sufficiently tie executive pay to company performance. *Beazer Homes*, 2011 WL 4836230, at 3. Most often, this occurs when pay is increased despite a decrease in company earnings or share price. *See Cincinnati Bell*, 2011 WL 4383368, at *1; *see also Beazer Homes*, 2011 WL 4836230, at 3.

226. Benson, *supra* note 200 at *2; *see also Beazer Homes*, 2011 WL 4836230, at 3.

227. Metz, *supra* note 9, at 285–86.

Courts have largely rejected these claims.[228] A Georgia Superior Court, applying Delaware law, dismissed claims against the directors at Beazer Homes on the ground that plaintiffs lacked standing, failed to allege excuse for failure to make a pre-suit demand on the directors, and failed to state a claim.[229] In *Beazer Homes*, plaintiffs attempted to excuse demand under the second prong of the *Aronson* demand futility test,[230] which requires alleging facts to raise a reasonable doubt that the directors' executive compensation decisions reflected valid business judgment.[231] The court noted that plaintiffs failed to allege particularized facts to rebut the presumption of the business judgment rule, but instead relied on the failed say-on-pay vote to rebut the presumption.[232] The court then emphatically rejected this argument, noting that the decisions were made prior to the say-on-pay vote.[233] It went further to note that the judgment of the shareholders (as evidenced by the failed vote) as a rebuttal to the presumption of business judgment had no support in Delaware, or in the statutory language of the Dodd-Frank Act.[234]

The Act expressly and unambiguously states that the say-on-pay vote is non-binding on the issuer and the board, and that it preserves the pre-existing fiduciary duty framework for directors.[235] The court concluded that a failed say-on-pay vote alone will not suffice to rebut the presumption of business judgment.[236] As a result, and due to the lack of other alleged facts, plaintiffs did not rebut the presumption of business judgment, and therefore failed to allege excuse for their failure to make pre-suit demand.[237]

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228. Benson, *supra* note 200, at *3.

229. *Beazer Homes*, 2011 WL 4836230, at 4.

230. Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984). *Id.*

231. *Beazer Homes*, 2011 WL 4836230, at 9.

232. *Id.* at 10.

233. *Id.* The court's rejection is consistent with the well-established principle that disallowing this type of hindsight used to second-guess a board's decision is the essential purpose of the business judgment rule. Brehm v. Eisner, 746 A.2d 244, 260 (Del. 2000).

234. *Beazer Homes*, 2011 WL 4836230, at 11.

235. 15 U.S.C. § 78n-1(c) (2012).

236. *Beazer Homes*, 2011 WL 4836230, at 12 ("Given that Delaware law, which the Dodd-Frank Act explicitly declined to alter, places authority to set executive compensation with corporate directors, not shareholders, this Court will not conclude that an adverse say on pay vote *alone* suffices to rebut the presumption of business judgment protection applicable to director's compensation decisions.").

237. *Id.*

A number of other derivative suits following a failed say-on-pay vote found similar fates.[238] The court in *Umpqua Holdings*, following the "clear and well-taken" reasoning of the *Beazer Home* court, dismissed on demand futility grounds similar shareholder plaintiff claims against the company's directors.[239] The court distinguished the *Cincinnati Bell* case on the grounds that it applied a different legal framework, i.e., Ohio law, and noted the decision was unlikely to remain viable legal authority.[240] Instead, the court applied Delaware law, noting that the Dodd-Frank Act explicitly declined to alter existing Delaware law, leaving the authority to set executive compensation with directors, not shareholders.[241]

In the *PICO Holdings* case, plaintiffs sought declaratory judgment that the failed say-on-pay vote rebutted the presumption of business judgment.[242] The court, applying federal law, concluded that plaintiffs failed to state a claim for declaratory judgment and dismissed the request.[243] The court based its conclusion on the fact that the Dodd-Frank Act did not change state law regarding fiduciary duty or the business judgment presumption.[244] The court then declined to exercise supplemental jurisdiction and remanded the remaining state law claims.[245]

These decisions contrast sharply with that of *Cincinnati Bell*.[246] The Southern District of Ohio, applying Ohio law, denied defendant's motion to dismiss.[247] The court quotes Ohio precedent in noting that the business judgment rule imposes a burden of proof, not a burden of pleading, in order to establish

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238. *E.g.*, Plumbers Local No. 137 Pension Fund v. Davis (*Umpqua Holdings*), Civ. No. 03:11-633-AC, 2012 WL 104776 (D. Or. Jan. 11, 2012); Dennis v. Hart (*PICO Holdings*), No. 11-CV-2271 WQH, 2012 WL 33199 (S.D. Cal. Jan. 6, 2012); *In re* Jacobs Eng'g Grp. Inc. Consol. S'holder Derivative Litig., No. BC454543 (Cal. Super. Ct. Mar. 6, 2012) (order granting demurrer); Laborers' Local v. Intersil, 866 F. Supp. 2d 838 (N.D. Cal. 2012); Weinberg *ex rel.* BioMed Realty Trust, Inc. v. Gold (*BioMed Realty*), 838 F. Supp. 2d 355 (D. Md. 2012). *See Failed Say on Pay Litigation—Digest of Cases*, *supra* note 221, for a full digest of say-on-pay litigation, including links to complaints, trial orders, and articles.

239. *Umpqua Holdings*, 2012 WL 104776, at *8.

240. *Id.*

241. *Id.* (quoting *Beazer Homes*, 2011 WL 4836230, at 12).

242. *PICO Holdings*, 2012 WL 33199, at *2.

243. *Id.* at *3.

244. *Id.*

245. *Id.* at *4-5.

246. NECA–IBEW Pension Fund *ex rel.* Cincinnati Bell, Inc. v. Cox, No.1:11-cv-451, 2011 WL 4383368 (S.D. Ohio Sept. 20, 2011).

247. *Id.* at *3.

facts to rebut its presumption of good faith.[248] The court concluded that plaintiffs met this burden, and allowed the case to proceed.[249] In support of the sufficiency of plaintiff's claim, the court points to plaintiff's assertion that the failed say-on-pay vote provides "direct and probative" evidence that the director's decision regarding compensation were not in the best interests of shareholders.[250] Ignoring the issue of timing addressed in the *Beazer Home* case, and without any facts indicating abuse or bad faith, the court contravenes the very purpose of the business judgment rule by allowing hindsight to be used to second-guess director decisions.[251]

The *Cincinnati Bell* court went further to excuse the pre-suit demand requirement on the grounds that the directors whose decisions are being challenged could not make "unbiased, independent business judgments about whether to sue."[252] This conclusion seemingly uproots the application of the demand requirement in derivative actions.[253] If a director's involvement in a challenged matter would disqualify him from evaluating a derivative claim, then pre-suit demand would be futile in all but a few cases, and the requirement would no longer serve its purpose.[254] The troubling nature of these conclusions has led many commenters to cast this case as an aberration, predicting that most courts will not follow its lead.[255]

D. *Application*

Aside from *Cincinnati Bell*, derivative suits following failed say-on-pay votes have largely been dismissed under the holding that the failed vote alone does not rebut the presumption of business judgment.[256] This is consistent with the advisory

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248. *Id.* at *2 ("[P]laintiffs are not . . . obligated to plead operative facts in their complaint that would rebut the presumption.").

249. *Id.* at *3 ("These factual allegations raise a plausible claim that [the directors' decisions] were not in the best interests of Cincinnati Bell's shareholders and therefore constituted an abuse of discretion or bad faith.").

250. *Id.* at *3 n.4.

251. *See* Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).

252. *Cincinnati Bell*, 2011 WL 4383368, at *3.

253. *See* DEL. CH. CT. R. 23.1(a).

254. *See* Aronson v. Lewis, 473 A.2d 805, 811-12 (Del. 1984) ("[T]he demand requirement . . . exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits."). It should be noted that this purpose hews from Delaware law, and *Cincinnati Bell* was decided under Ohio law. *Cincinnati Bell*, 2011 WL 4383368, at *1.

255. Benson, *supra* note 200, at *2.

256. Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy (*Beazer Homes*), No. 2011–cv-197841, 2011 WL 4836230, at 12 (Ga. Super. Ct. Sept. 16, 2011).

nature of the say-on-pay vote and the express intention of the Dodd-Frank Act to preserve the pre-existing fiduciary duty framework for directors.[257] Therefore, it is evident that the result of a say-on-pay vote should not have a determinative impact on the well-established business judgment rule.[258] Taken further, where directors are disinterested and independent, absent facts suggesting abuse or lack of good faith, courts should systematically reject derivative claims arising from the result of a say-on-pay vote.[259] The challenged director decisions in these actions should be afforded protection by the business judgment rule.[260]

Of the opinions issued so far, it would appear that most courts are unwilling to disregard established corporate jurisprudence in favor of what appear to be frivolous claims.[261] However, with the possibility of large settlements, it is unlikely that plaintiffs will be deterred.[262] This is important for two reasons. First, with the adoption of mandatory say-on-pay came a new surge of opportunistic executive pay litigation.[263] Second, the consequences of these seemingly meritless shareholder claims threaten issuers' ability to operate in the best interest of shareholders.[264]

As discussed above, shareholders have expressed their dissatisfaction with executive pay through derivative litigation for some time now.[265] However, the recent cases have come at a significantly higher rate.[266] The driving force behind this recent

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257. 15 U.S.C. § 78n-1(c) (2012).

258. *See Brehm*, 746 A.2d at 264 n.66.

259. *See id.*

260. *See id.*

261. Metz, *supra* note 9, at 286.

262. Kyoko Takahashi Lin & Lawrence Portnoy, *Say-on-Pay Litigation Update*, DAVISPOLK BRIEFING: GOVERNANCE (Sept. 5, 2012, 3:08 PM), http:// www.davispolk.com/ briefing/corporategovernance/61662/. In fact, it would appear they have not been. *Id.* New opportunities for shareholder litigation arise from the alleged failure of boards to rescind compensation or substantively adjust compensation practices following a failed say-on-pay vote. *Id.* Additionally, in 2012, shareholders began filing preliminary injunctions, based on inadequate compensation disclosures, in an attempt to keep the shareholder vote from taking place. *See* Sarah A. Good et al., *Plaintiffs' Firms Gaining Steam in New Wave of Say-On-Pay Shareholder Suits?*, PILLSBURYLAW.COM 3 (Nov. 19, 2012), http:// www.pillsburylaw.com/siteFiles/Publications/AlertNovember2012LitigationPlaintiffs FirmsGainingSteaminNewWaveofSayOnPayShareholderSuits.pdf.

263. Metz, *supra* note 9, at 285.

264. *Id.* at 294.

265. Thomas & Martin, *supra* note 5, at 570-71; Metz, *supra* note 9, at 285.

266. Thomas & Martin, *supra* note 5, at 573-74. From 1912 to 2000, a span of 88 years, the authors collected 124 cases. *Id.* In the past several years, there have been more than twenty cases related only to say-on-pay. *Failed Say on Pay Litigation—Digest of Cases*, *supra* note 221.

surge is the implementation of mandatory say-on-pay under the Dodd-Frank Act.[267] This is troubling considering that the say-on-pay vote is non-binding, does not change or add any fiduciary duties of directors, and does not create a private right of action.[268] It is ironic that a tool intended to enhance shareholder-to-director communication was rejected immediately by some shareholders in favor of a tool that typically hinders communication: litigation.[269] The communication enhancing tool has instead been used as a justification to avoid communication altogether.[270]

Despite these intended barriers to using say-on-pay vote results in a derivative claim, plaintiffs have cleverly and opportunistically done.[271] It may be sincerely argued that the say-on-pay vote result is merely an element of the derivative action, and that the action would stand without it.[272] However, this is inconsistent with the pleadings in these actions, and is altogether untrue.[273] Each of these actions followed a failed (or otherwise unsuccessful) say-on-pay vote, and without the vote result, would not have been filed.[274] But for the implementation of say-on-pay, the recent surge of derivative suits would not exist.[275] The end result may very well be improved corporate governance and executive compensation practices, but that is unlikely.[276]

The more likely consequence of the recent say-on-pay litigation brought by shareholders is a decrease in shareholder

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267. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899-1900 (2010)(codified as amended at 15 U.S.C. § 78n).

268. 15 U.S.C. § 78n-1(c) (2012); *see also* Alexander v. Sandoval, 532 U.S. 275, 286-87 (2001) ("[P]rivate rights of action to enforce federal law must be created by Congress. . . . Without it, a cause of action does not exist and courts may not create one, no matter how desirable that might be as a policy matter . . . .").

269. *See* Brehm v. Eisner, 746 A.2d 244, 267 (Del. 2000). The vast majority of this litigation was initiated immediately after shareholders voted against say-on-pay, precluding the opportunity for directors to engage in constructive communication with shareholders regarding the reasons for the failed vote. *See* Metz, *supra* note 9, at 285.

270. *See* Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy (*Beazer Homes*), No. 2011–cv-197841, 2011 WL 4836230, at 12 (Ga. Super. Ct. Sept. 16, 2011).

271. Metz, *supra* note 9, at 294.

272. *See Beazer Homes*, 2011 WL 4836230, at 12.

273. *See* Complaint at 1-2, Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy (*Beazer Homes*), No. 2011–cv-197841, 2011 WL 901905 (Ga. Super. Ct. Mar. 15, 2011). The Beazer complaint is structured similarly to those in other cases. A key element of the complaint is that the adverse shareholder vote on executive compensation rebuts the presumption of business judgment. *Id.*

274. *E.g.*, *Beazer Homes*, 2011 WL 4836230, at 3.

275. See Metz, *supra* note 9, at 285.

276. *See* Thomas & Martin, *supra* note 5, at 573.

value.[277] The company, and as a result, shareholders, are harmed by these suits in a number of ways, including the loss of directors' time better spent overseeing the company, bad publicity, litigation expenses, and the resulting limited ability to attract new, qualified directors.[278] Additionally, companies without the resources to fight this litigation may be forced to settle.[279] Settlement provides no benefit to the shareholders, but merely enhances the plaintiff's bar.[280] The end result of this wave of litigation is likely a burden on the company, and a resulting burden on the very shareholders that bring it.

Because of the potential detriment to the corporation, courts should reject challenges to executive compensation arising out of a failed say-on-pay vote. The challenged decisions clearly fall under the protection of the business judgment rule.[281] Its essence is that a court will not use hindsight to second guess a board's decision.[282] The implementation of a mandatory advisory vote on executive compensation under the Dodd-Frank Act does nothing to disturb this protection.[283] Despite this protection, numerous derivative lawsuits attempting to rebut the presumption of business judgment have been filed by shareholders following an adverse say-on-pay vote,.[284] While largely unsuccessful, the possibility of a payoff may keep plaintiff attorneys from being deterred.[285] In any case, as long as disinterested directors make informed decisions in good faith and in the best interest of the corporation courts should dismiss all claims arising from a failed say-on-pay vote.[286]

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277. *See* Brehm v. Eisner, 746 A.2d 244, 255 (Del. 2000). A shareholder's "quixotic pursuit of a purported corporate claim based solely on conclusions, opinions or speculation" causes the corporation to "expend money and resources in discovery and trial." *Id.*

278. Metz, *supra* note 9, at 294. Companies and directors may be protected by directors' and officers' liability insurance coverage, but claims against the policy would likely increase future coverage costs. *Id.*

279. Good et al., *supra* note 262, at 3-4. Two companies sued in 2010 settled with attorney fees ranging from $1 to $1.75 million. *Id.*

280. Metz, *supra* note 9, at 294.

281. *See* Brehm at 264 n.66.

282. *Id.* at 260.

283. 15 U.S.C. § 78n-1 (2012). Say-on-pay should also have no impact on a court's determination of demand futility. *See id.*

284. Metz, *supra* note 9, at 287.

285. *Id.* at 294.

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

V. CONCLUSION

Although executive pay levels are substantial, it is the "essence of business judgment for a board to determine if a particular individual warrants large amounts of money."[287] This construct leaves some shareholders dissatisfied,[288] despite being afforded the protection of compensation committee independence and robust executive compensation disclosures, and despite wielding the power to sell stock or vote against directors.[289] Even with these protections and powers in place, shareholders who disagree with the executive compensation decisions of directors resort instead to costly litigation.[290]

The business judgment rule protects the decisions of directors in determining executive compensation from challenges by shareholders.[291] In fact, where disinterested directors make informed decisions in good faith and in the best interest of the company, courts should routinely reject executive compensation challenges.[292]

Independent directors make decisions on executive compensation.[293] Shareholders make decisions on whether to sell the stock, vote against the directors, or express their dissatisfaction through say-on-pay.[294] This separation of power is protected by the business judgment rule, courts should be wary to disturb this.[295]

Kevin Schott

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287. *Brehm*, 746 A.2d at 263 ("[T]he size and structure of executive compensation are inherently matters of judgment.").

288. Thomas & Martin, *supra* note 5, at 569.

289. Thomas & Martin, *supra* note 5, at 569-70.

290. *Id.* at 570-71.

291. *Brehm*, 746 A.2d at 264 n.66.

292. *Id.*

293. DEL. CODE ANN. tit. 8, § 122(5) (West 2012).

294. *See* Thomas & Martin, *supra* note 5, at 569-70.

295. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).