Say-on-Pay with Bite: Shareholder Derivative Suits on Executive Compensation

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 mandated shareholder advisory voting for executive compensation in public corporations. This vote, known as "say-on-pay," enables shareholders to provide input on the size and nature of executive compensation packages. The impetus behind mandating say-on-pay is the concern that corporate executive pay has grown increasingly excessive. To that end, say-on-pay has not been successful, as the first three years of voting have not produced a significant effect on executive pay. However, the voting results have suggested changes in other ways, indicating that shareholders can be influenced in the decisionmaking process for executive pay.

Due to the advisory nature of say-on-pay, shareholders have few methods of recourse in the event that a corporation chooses to ignore shareholder input. Shareholders generally lack sufficient power to influence corporations and their boards. Shareholders have had little success through litigation, as courts have been reluctant to consider a say-on-pay vote as the basis for establishing demand futility, a pleading requirement for shareholder derivative suits.

This Note argues that a say-on-pay vote should be sufficient for establishing demand futility in limited circumstances. Courts should apply a stricter standard of judicial review when directors ignore a say-on-pay vote, placing the onus on the directors to show that they properly considered the vote, and that the compensation packages for executives were reasonable. Enabling shareholders to use the threat of litigation provides extra muscle for say-on-pay, making it a more effective mechanism for controlling executive pay.

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INTRODUCTION

Executive pay has long been a source of controversy, and in recent years, some have attributed the housing bubble and subsequent financial crash in the United States to executive compensation. Judge Richard Posner noted that a "particularly insidious effect of executive overcompensation . . . is the incentive it imparts to CEOs to ride a bubble until it bursts."[1] The higher the pay to CEOs, and the more that pay is tied to the price of the company's stock, the more CEOs are incentivized to maximize profits in the short run.[2] This explains why CEOs were much more willing to engage in risky overleveraging of debt during an economic bubble.[3]

The criticism aimed at executive pay practices after the financial crash was not merely a matter of hindsight. A study of Fannie Mae's executive pay arrangements, conducted by Lucian Bebchuk and Jesse Fried several years before the housing bubble burst, revealed serious

1. Richard A. Posner, *Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1041 (2009).

2. *Id.*

3. *Id.*

flaws at the company.[4] The study found that Fannie Mae's compensation arrangements incentivized executives to report higher earnings regardless of whether those reports were misstated and to offer generous retirement packages regardless of overall performance failure.[5] Such practices were not atypical; to the contrary, they were "representative of prevailing compensation practices in public companies."[6]

Historically, shareholders have had little say on executive pay . This is largely because shareholders have little incentive to be active in internal matters concerning the corporation. As a general rule, shareholders are considered to be "rationally apathetic" because the effort that is required to make informed decisions is much greater than the benefits, which are low, because most shareholders have too small of a stake in the corporation to have any influence in making changes.[7] Due to their inability to effect change, shareholders typically adhere to the so-called "Wall Street Rule": that it is easier to sell their shares than it is to fight.[8] Accordingly, shareholders who may be critical of the pay executives receive have no reason to push for change because they have little power to do so. Shareholders opposed to the current executive pay regime are thus left with only two rational choices: sell their shares in the firm or keep quiet.

In response to the financial crisis, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") into law in 2010, resulting in the most significant reform to the financial regulatory system since the Great Depression.[9] This Note examines one of the provisions designed to provide shareholders with input on executive compensation: the ability to vote to either approve or disapprove of executive pay packages, otherwise known as "say-on-pay." While say-on-pay has triggered significant changes to how executives are paid, there are few repercussions for corporations that choose to ignore shareholder demands. Shareholders who bring derivative suits against corporate directors for failing to consider the votes have been unsuccessful getting past the motion to dismiss stage of litigation because courts are reluctant to consider a failed vote as the basis for demand futility, a procedural

4. *See generally* Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807 (2005).

5. *Id.* at 807–08.

6. *Id.* at 822.

7. STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 56–57 (2008).

8. *Id.* at 202–03.

9. Brian Montopoli, *Obama Signs Sweeping Financial Reform into Law*, CBS NEWS (July 21, 2010, 2:23 PM), http://www.cbsnews.com/8301-503544_162-20011201-503544.html. For a synopsis of the history of U.S. financial regulatory reforms, see Wenzhong Zhu & Shen Rui, *The Historical Dimension of the US Dodd-Frank Bill and Its Implications to the Financial Governance Reform in Emerging Markets*, 5 iBUSINESS 146, 147–48 (2013).

requirement for derivative suits.[10] This Note argues that a failed say-on-pay vote, particularly one that relied on a proxy advisory firm's recommendation to reject a board's pay proposal, should be sufficient to excuse pre-suit demand for a derivative suit. Courts should begin to apply enhanced scrutiny to situations in which a company's board of directors ignored the say-on-pay vote. This would present such situations as compelling evidence that would rebut the business judgment rule as required under the Delaware *Aronson* test to establish demand futility.

Part I of this Note discusses background on executive compensation, including the considerable rise of executive pay over the past three decades, as well as arguments regarding changes in how executives are paid. Part II surveys the history of say-on-pay prior to Dodd-Frank. Part III discusses the results of say-on-pay under Dodd-Frank. While say-on-pay has not managed to lower executive pay during the first two years of voting, it has resulted in significant changes in the relationship between shareholders and the corporation. Part IV examines say-on-pay derivative suits and concludes that courts should find failed say-on-pay votes, in certain contexts, to be sufficient to survive motions for dismissal.

I. Background on Executive Compensation

The primary impetus behind say-on-pay and other rules directed at corporate pay packages is the perception that executive compensation has grown increasingly excessive. That belief has long been a source of public outrage and controversy.[11] Whether that perception reflects reality has been an area of dispute among academics and lawmakers, as discussed below. Before say-on-pay is further discussed, it is helpful to understand the trends of executive pay over the years and the arguments over whether changes to compensation are necessary.

A. Growth of Executive Pay

Although executive compensation has been a contentious issue since the 1930s, the rapid growth trends of today only began in the mid-1970s.[12] Since then, growth rates in executive pay have soared.[13] In monetary terms, the average salary for CEOs of Standard & Poor's 500

10. Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 108–09 (1991) (establishing the requirement of demand futility).

11. *See* Harwell Wells, *"No Man Can Be Worth $1,000,000 a Year": The Fight over Executive Compensation in 1930s America*, 44 U. Rich. L. Rev. 689, 690 (2010) (stating that the issue of excessive compensation in the U.S. arose first during the 1930s).

12. Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936–2005*, 23 Rev. Fin. Stud. 2099, 2100 (2010).

13. *Id.* at 2106–07.

companies, adjusted for inflation, increased from $3.7 million in 1993 to $17.4 million in 2000.[14]

This rise in the growth rate of CEO compensation would perhaps not be so alarming if pay also increased for employees of these CEOs' companies. But this is not the case. CEO pay increased from twenty times the average employee pay in 1965 to nearly fifty-six times the employee pay in 1989 and 106.9 times the pay in 1999.[15] For large companies, the ratio of CEO pay to average employee pay was even more pronounced. In 1991, CEOs of large companies were paid 140 times the average employee pay.[16] The ratio skyrocketed in the twenty-first century, with CEOs making 500 times employee pay in 2003.[17] The significant rise in executive pay, then, is not simply the result of the pie growing bigger in size; rather, the executives' slice of the pie seems to have grown larger, and significantly so, at the expense of the employees' slice.

B. Explanations for the Growth of Executive Pay

While it is undeniable that executive compensation has increased significantly in recent decades, the debate continues over whether the rise in pay is justifiable in terms of firm success or economic conditions. Bebchuk and Yaniv Grinstein argue that this substantial growth in executive compensation cannot be explained simply by firm size, performance, and industry trends because only "the relationship between pay and firm attributes has changed substantially."[18] Other economists and legal academics have also attempted to explain the enormous rise in pay awarded CEOs in a number of ways.

Some scholars argue that competition is one explanation for the rise in CEO pay. Xavier Gabaix and Augustin Landier argue in a recent influential article that the "sixfold increase in CEO pay between 1980 and 2003 can be attributed to the sixfold increase in market capitalization of large U.S. companies during that period," showing that CEO pay increases with the size of the firm.[19] Charles Yablon contends that the trend toward more transparency and disclosure in regards to executive

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14. Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 Oxford Rev. Econ. Pol'y 283, 285 (2005).

15. Lynne L. Dallas, *Short-Termism, the Financial Crisis and Corporate Governance*, 37 J. Corp. L. 265, 321 (2012).

16. Lucian Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation 1 (2004) [hereinafter Bebchuk & Fried, Pay Without Performance]. "Large" companies refers to those listed on the Standard & Poor's 500. *Id.*

17. *Id.*

18. Bebchuk & Grinstein, *supra* note 14, at 289.

19. Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q. J. Econ. 49, 50 (2008).

compensation has actually increased the amount that CEOs are paid.[20] According to Yablon, boards tend to believe that their CEO is at least "above-average" and use the disclosed information to give their CEO above-average pay, leading to a "ratcheting up" of compensation paid to CEOs.[21] Kevin Murphy and Jan Zabojnik argue that the increase in CEO pay has been driven "by an increase in the importance of general skills, as opposed to firm-specific knowledge, in managing the modern corporation."[22] As a result, firms have competed with one another to make external CEO hires, offering higher pay to attract outside talent.[23]

A significant explanation for the rise in executive pay arises from the "agency problem." The agency problem results from the separation of ownership and management that characterizes the corporate structure of publicly traded American firms.[24] The owners (the shareholders) of the corporation are not in a position to regularly monitor the actions of the corporation's management (the executives).[25] Accordingly, those managers have substantial discretion over how the corporation is run.[26] This dynamic creates an agency relationship, where the managers act as agents on behalf of the corporation's shareholders.[27] This relationship creates the potential that managers will take actions that are not in the best interests of the shareholders because the interests of the manager-agents do not always align with those of the shareholder-principals.[28]

In the context of compensation, executives are thus in a position to exercise their discretion to benefit themselves financially at the expense of the corporation and its shareholders. The agency problem arises from the relationship between management and supervision of management by the corporation's board of directors,[29] which has the authority to negotiate and approve compensation packages.

Advocates of the Board Capture theory, or Managerial Power Perspective, argue that negotiations are not the result of arm's-length bargaining because the executives have effectively taken control over, or

20. Charles M. Yablon, *Is the Market for CEOs Rational?*, 4 N.Y.U. J.L. & BUS. 89, 113 (2007) (reviewing BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 16).

21. *Id.* at 112. *See* John M. Bizjak et al., *Does the Use of Peer Groups Contribute to Higher Pay and Less Efficient Compensation?*, 90 J. FIN. ECON. 152, 153 (2008) (finding in a study of one hundred Standard & Poor's 500 firms' compensation committee reports in 1997 that the "vast majority" of firms pegged compensation at or above the median).

22. Kevin J. Murphy & Ján Zábojník, *CEO Pay and Appointments: A Market-Based Explanation for Recent Trends*, 94 AM. ECON. REV. 192, 195 (2004).

23. *Id.*

24. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 110–11 (1934).

25. BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 16, at 15.

26. *Id.*

27. *Id.* at 16.

28. *Id.*

29. *Id.* at 17.

captured, the board of directors.[30] These advocates assert that compensation arrangements often deviate from arm's-length contracting due to management's control over the directorial nomination process. Therefore, directors have an incentive to comply with the wishes of the managers.[31] Other factors further incentivize directors to comply with the managers' wishes. Bebchuk and Fried argue that "because being on the company's slate is the key to being appointed, developing a reputation for haggling with the CEO over compensation would hurt rather than help a director's chances of being invited to join other companies' boards."[32] Additionally, "limitations on time and resources have made it difficult for even well-intentioned directors to do their pay-setting job properly."[33] As a result, managers are able to obtain rents, or benefits that surpass what would have been feasible under normal arm's-length bargaining.[34]

Such explanations for the rise in executive pay suggest that shareholders can and should have a role not only in keeping executive pay from growing too excessively, but also making the executive pay-setting process more efficient. Part II discusses one of the components of Dodd-Frank that is intended to accomplish these objectives: say-on-pay.

II. Background on Say-on-Pay

A. Shareholder Primacy

The idea that shareholders can influence executive compensation is based in part on a theory known as "shareholder primacy," which prioritizes the value of shareholders' interest in the corporation.[35] According to the theory, maximizing the value of the shareholders' interest maximizes the value of the corporation itself.[36] The theory is based

30. *See* Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 Minn. L. Rev. 846, 852 (2011). An arm's-length transaction refers to one "between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power." Black's Law Dictionary 123 (9th ed. 2009).

31. Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. Econ. Persp. 71, 73 (2003) [hereinafter Bebchuk & Fried, *Agency Problem*]. In contrast, advocates of the Optimal Contract theory contend that executive compensation is generally a matter of efficient negotiations due to arm's-length bargaining and market constraints that inhibit misconduct during the negotiation process. *See* Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. Rev. 299, 315 (2009). Although they do not completely reject the Optimal Contract theory, adherents of the Board Capture theory contend that the "departures [from optimal outcomes in directions favorable to managers] are substantial and that optimal contracting alone cannot adequately explain compensation practices." Bebchuk & Fried, *Agency Problem*, *supra*, at 73.

32. Bebchuk & Fried, *Agency Problem*, *supra* note 31, at 74.

33. Bebchuk & Fried, Pay Without Performance, *supra* note 16, at 4.

34. *Id.*

35. *See* Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 36 (1991).

36. *Id.*

on the agency relationship described above: the managers act as agents of the shareholder-principals. But given the separation of ownership and management, the shareholders are really not the "owners" of the corporation, but one group out of many that contract with the corporate entity.[37] Unlike the other contractual parties to the firm—such as creditors, suppliers, or employees—the shareholders are residual claimants to the firm's income.[38] This means that shareholders do not receive their returns on the firm until the other contracting parties do. As the claimants to the residual income, shareholders are the only parties with "the appropriate incentives . . . to make discretionary decisions" because they "receive most of the marginal gains and incur most of the marginal costs."[39] In other words, the other contracting parties collect a set amount of income from the firm regardless of the firm's performance. Because shareholder income is dependent on the remaining funds, shareholders are incentivized to make the appropriate discretionary decisions on behalf of the firm in order to maximize the firm's performance and subsequent wealth.

Voting, or the ability to exercise discretion, enforces shareholder primacy by incentivizing managers to act in the interest of the shareholders.[40] Managers act in the interests of shareholders because shareholders monitor their actions, and can vote at any time to oust management.[41] Thus, a say-on-pay vote may have the ability to influence how executives are paid because failing to consider the input of shareholders on compensation matters could lead to serious retribution against management. Below, this Note examines how say-on-pay has been implemented prior to Dodd-Frank, including its conception in the United Kingdom.

B. Say-on-Pay Prior to Dodd-Frank

Adoption of say-on-pay in the United States was influenced largely by the United Kingdom's experience with the practice.[42] In 2002, the United Kingdom was the first country to adopt rules for advisory shareholder voting on executive compensation.[43] Say-on-pay has not yet

37. *Id.* at 67.

38. *Id.*

39. *Id.* at 68. *But see* Bainbridge, *supra* note 7, at 70 ("[S]hareholders have no meaningful voice in corporate decision making. In effect, shareholders have but a single mechanism by which they can 'negotiate' with the board: withholding capital.").

40. Easterbrook & Fischel, *supra* note 35, at 68–69.

41. *Id. But see* Bainbridge, *supra* note 7, at 15–16 ("[S]hareholder voting is properly understood not as an integral aspect of the corporate decision-making structure, but rather as an accountability device of last resort to be used sparingly, at best.").

42. Fabrizio Ferri & David A. Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK*, 17 Rev. Fin. 527, 528 (2013).

43. *Id.* at 527.

impacted the growth rate of executive pay,[44] and less than a dozen companies have received negative votes in the six years since the rule was enacted.[45] However, Fabrizio Ferri and David Maber's empirical study found that say-on-pay has "pressure[d] firms to remove controversial pay practices" and link pay closer with performance.[46]

Such controversial pay practices included generous severance packages, as reflected most visibly in the case of GlaxoSmithKline in 2003. There, the pharmaceutical company CEO's golden parachute,[47] which would have entitled the chief executive to an additional $23.7 million in salary and stock upon resignation or termination, was rejected in a tight vote.[48] While the advisory vote did not mandate that GlaxoSmithKline make any changes, the following year the company drastically cut the size of the severance package in order to gain shareholder approval.[49] But more importantly, the GlaxoSmithKline affair produced a fundamental change in the relationship between companies and their shareholders. Shortly thereafter, "companies and shareholders that never used to talk to each other over [compensation policies have begun to engage] in a constructive, not a hostile, but a constructive and regular annual dialogue on this important issue."[50]

Prior to Dodd-Frank, shareholders introduced say-on-pay in the United States pursuant to Securities Exchange Commission ("SEC") Rule 14a-8, which governs shareholder proposals.[51] In 2006, the American Federation of State, County and Municipal Employees introduced say-on-pay resolutions on seven shareholder ballots in the United States.[52]

44. *Id.* at 554.

45. Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 343 (2009).

46. Ferri & Maber, *supra* note 42, at 530.

47. Golden parachutes refer to "agreements between a corporation and its top officers which guarantee those officers continued employment, payment of a lump sum, or other benefits in the event of a change of corporate ownership." Schreiber v. Burlington N., Inc., 472 U.S. 1, 3 n.2 (1985). Golden parachutes are often criticized because they "unjustifiably waste corporate assets and create perverse performance incentives." Richard P. Bress, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 955 (1987).

48. Heather Timmons, *Glaxo Shareholders Revolt Against Pay Plan for Chief*, N.Y. TIMES, May 20, 2003, at W1. Shareholders rejected the pay package by a margin of 50.72% to 49.28%. *Id.*

49. *GSK Gets Approval for Pay Deals*, BBC NEWS (May 17, 2004, 8:02 PM), http://news.bbc.co.uk/2/hi/business/3723151.stm.

50. *Empowering Shareholders on Executive Compensation: H.R. 1257, The Shareholder Vote on Executive Compensation Act: Hearing Before the Comm. on Fin. Services*, 110th Cong. 14 (2007) (statement of Stephen M. Davis); STEPHEN DAVIS, MILLSTEIN CTR. FOR CORP. GOVERNANCE & PERFORMANCE, YALE SCH. OF MGMT., DOES 'SAY ON PAY' WORK? LESSONS ON MAKING CEO COMPENSATION ACCOUNTABLE 10 (2007).

51. Randall S. Thomas et al., *Dodd-Frank's Say on Pay: Will it Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213, 1218 (2012).

52. *Empowering Shareholders on Executive Compensation: H.R. 1257, The Shareholder Vote on Executive Compensation Act: Hearing Before the Comm. on Fin. Servs.*, 110th Cong. 10 (2007) (statement of Richard Ferlauto, Dir. of Pension & Benefit Policy, Am. Fed. of State, Cnty. & Mun. Emps.).

Although all seven proposals failed to receive a majority vote, it was not long before voters approved such measures.[53] The following year, shareholders voted to approve say-on-pay at Activision, Blockbuster, Par Pharmaceuticals, Ingersoll-Rand, Motorola, Verizon, and Clear Channel Communications.[54] In the same year, the pension fund Teachers Insurance and Annuity Association-College Retirement Equities Fund became the first entity to offer a say-on-pay vote to policyholders.[55] In 2008, Aflac became the first publicly traded company to offer say-on-pay for shareholders.[56] Such piecemeal efforts were the only feasible method of enacting say-on-pay, as legislative attempts to pass say-on-pay at the federal level continuously failed to gain traction.

Prior to Dodd-Frank, Congress made several attempts to pass say-on-pay legislation. In 2005, Representative Barney Frank introduced the Protection Against Executive Compensation Abuse Act of 2005, which would have amended the Securities Exchange Act of 1934 to mandate a say-on-pay vote.[57] Frank attempted legislation twice more, in 2007[58] and 2009,[59] but ultimately, none of his bills were brought to a vote. In the Senate, Senator Charles Schumer introduced a bill in 2009.[60] Like its counterpart in the House, the Senate never voted on the bill.

In 2009, Congress finally adopted a limited version of say-on-pay, which only reached financial firms that received federal aid under the Troubled Asset Relief Program ("TARP").[61] The American Recovery and Reinvestment Act of 2009 (the federal stimulus plan) also required a say-on-pay vote for companies that had outstanding TARP debt.[62] These efforts by Congress occurred in response to public criticism that TARP funds were being used to pay out executive bonuses.[63] However, this version of say-on-pay appears to have had little to no impact on compensation for companies subject to the vote. By the end of 2009, virtually every company that received TARP funds received shareholder approval on executive pay packages.[64]

53. *Shareholder Advisory Votes on Executive Compensation—A "Say on Pay" Primer*, COMPENSIA (June 22, 2009), http://www.compensia.com/tp_alerts/ThoughtfulPay_SayOnPay_0609.pdf.

54. *Id.*

55. Claudia H. Deutsch, *Aflac Investors Get a Say on Executive Pay, a First for a U.S. Company*, N.Y. TIMES, May 6, 2008, at C3.

56. *Id.*

57. Protection Against Executive Compensation Abuse Act, H.R. 4291, 109th Cong. (2005).

58. Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. (2007).

59. Corporate and Financial Institution Compensation Fairness Act, H.R. 3269, 111th Cong. (2009).

60. Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. (2009).

61. 12 U.S.C. § 5221(e) (2009).

62. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).

63. Thomas et al., *supra* note 51, at 1222.

64. Of the public companies that received TARP funds, 237 out of 282 disclosed results of the say-on-pay vote; of the 237 disclosing companies, all received shareholder approval. Cari Tuna,

The voting results seem to be independent of the firm's performance over the year, as evident in the case of Flagstar Bancorp, Inc., a publicly traded savings bank headquartered in Troy, Michigan.[65] Despite the fact that the stock price of the firm dropped from $6.94 in 2007 to $0.71 in 2008, and that the firm's CEO received a $1.5 million cash bonus "on account of 2008 performance," ninety-nine percent of its shareholders voted to approve the executive pay package.[66] The results from the 2010 proxy season did not show any significant difference, as shareholders approved pay proposals at TARP-funded companies by an average of nearly eighty-nine percent of the vote.[67]

III. Say-on-Pay Under Dodd-Frank

Section 951 of Dodd-Frank mandated say-on-pay for public corporations by amending section 14A of the Securities Exchange Act, which empowered the SEC to promulgate rules requiring shareholder votes on executive compensation.[68] The language of the statute provides that at least "once every 3 years, a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the Commission require compensation disclosure shall include a separate resolution subject to shareholder vote to approve the compensation of executives."[69] Say-on-pay under Dodd-Frank applies to the company's CEO as well as the executives named in the company's proxy compensation table.[70] The statute also requires shareholder voting on the frequency of the say-on-pay vote and the approval of golden parachute compensation in the event of an

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Investors Say 'Yes' on Pay at TARP Firms, Wall St. J. (Sept. 2, 2009, 12:59 PM), http://online.wsj.com/news/articles/SB125190043514279681.

65. *Id.*

66. *Id.*

67. Thomas et al., *supra* note 51, at 1224.

68. Dodd-Frank Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010) (codified as amended at 15 U.S.C. § 78n-1).

69. *Id.* (codified as amended at 15 U.S.C. § 78n-1(a)(1)). Shareholder voting procedures can be summarized as follows: "Under American corporate law, shareholders vote on company affairs in two main instances: they elect the board of directors and vote on proposals by management and fellow shareholders. Shareholder voting occurs predominately by proxy in advance of the company's annual meeting. Shareholders, in response to the company's proxy materials, grant a proxy for their shares to vote in a designated manner on a slate of candidates for the board and either up or down on a series of proposals by management and, in certain instances, proposals by other shareholders." *See* Michael S. Kang, *Shareholder Voting as Veto*, 88 Ind. L.J. 1299, 1305–06 (2013).

70. 17 C.F.R. § 240.14a-21(a) (2011). Under Item 402(b) of Regulation S-K, companies prior to a say-on-pay vote must "[d]iscuss the compensation awarded to, earned by, or paid to the named executive officers[;] . . . explain all material elements of the registrant's compensation of the named executive officers[; and] . . . describe . . . [h]ow the registrant determines the amount . . . for each element to pay." *Id.* § 229.402(b)(1).

acquisition or merger.[71] Interestingly, the statute also expressly pronounces that shareholder votes under the section are not to be construed "to create or imply any additional fiduciary duties for such issuer or board of directors."[72] As discussed below, this provision has largely prevented shareholders from using the courts to redress their grievances after a failed say-on-pay vote.

A. The Results of Dodd-Frank Say-on-Pay

1. The First Year: 2011

In 2011, the first year of mandatory shareholder voting under Dodd-Frank, the results seemingly showed that say-on-pay had little effect on executive compensation. For the 2011 proxy season, shareholders overwhelmingly approved of compensation proposals, while only thirty-six Russell 3000 companies[73] failed to receive majority support.[74] Additionally, nearly seventy-five of Russell 3000 companies prevailed on their say-on-pay vote with over ninety percent approval.[75] The 2011 results led one commentator to opine that "if the goal of these [say-on-pay efforts] is a reduction in compensation, the results are quite disheartening."[76]

But on closer review, the 2011 results may indicate a significant change in executive pay. While actual compensation figures have not declined, say-on-pay has appeared to significantly change corporate behavior and the relationship between corporate officials and shareholders. Commentators have argued that mandatory say-on-pay in its first year has "catalyzed greater management attention to shareholder concerns, an increased shareholder interest in voting on corporate governance, and a broader dialogue on pay issues between management and shareholders (and proxy advisory firms)."[77] According to this view, the numbers have not fully reflected the actual impact of say-on-pay.

There are several explanations for the discrepancy between the voting results and its actual impact. According to one study, many

71. Dodd-Frank Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010) (codified as amended at 15 U.S.C. § 78n-1(a), (b)).

72. *Id.* (codified as amended at 15 U.S.C. § 78n-1(c)(3)).

73. The Russell 3000 is a stock market index that measures the 3000 largest U.S. public companies based on total market capitalization, representing approximately ninety-eight percent of the investable U.S. equity market. *Russell 3000 Index*, Russell, http://www.russell.com/indexes/data/fact_sheets/us/russell_3000_index.asp (last visited Apr. 24, 2014).

74. *A Study of the Changes from a Failed 2011 Say on Pay Vote*, Equilar (Jan. 13, 2014), http://www.equilar.com/corporate-governance/2013-reports/a-study-of-the-changes-from-a-failed-2011-say-on-pay-vote.

75. *Id.*

76. Steven M. Davidoff, *Efforts to Rein in Executive Pay Meet with Little Success*, N.Y. Times, July 13, 2011, at B7.

77. Thomas et al., *supra* note 51, at 1256.

companies, prior to the 2011 proxy season and in anticipation of say-on-pay voting, preemptively made changes to their pay programs to better align pay with performance.[78] Changes often included eliminating non-performance-based pay elements such as excise tax gross-ups, executive perquisites, and large severance arrangements.[79] Similarly, some companies revised their pay programs after failing a prior vote, as in the cases of Occidental Petroleum and KeyCorp, two companies that voluntarily placed say-on-pay on the ballot in 2010.[80] The subsequent pay revisions experienced great success, winning shareholder approval in 2011 with 91.3% and 86.7% of the vote, respectively.[81] In 2012, compensation levels decreased significantly for companies that failed their 2011 vote.[82] Changes made by these companies in regard to executive pay suggest that companies "affirmatively react to [a failed] vote by reducing the level of increase of their executive compensation."[83]

Say-on-pay has also significantly impacted the level of communication between companies and their shareholders. Companies began to revise their Compensation Discussion & Analysis disclosures, using them not as "simply a compliance exercise," but also to "tell their story and provide a clear business rationale for their compensation decisions."[84] Companies that received negative recommendations from Institutional Shareholder Services ("I.S.S.") "increase[d] their communication with shareholders and re-evaluate[d] their compensation and corporate-governance practices."[85]

Perhaps the most interesting effect of say-on-pay voting during the 2011 proxy season has been management's response to failed votes. For most of the Russell 3000 companies that failed their votes, these companies responded by changing their pay practices in order to appease their shareholders.[86] For example, Stanley Black & Decker "significantly raised the minimum stock ownership required of its executive officers,"

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78. Russell Miller & Yonat Assayag, *SOP Drives Compensation Program Changes to Enhance Pay/Performance Link*, DIRECTOR NOTES, Sept. 2011, at 2. The study analyzed the first 100 proxy filings made by Fortune 500 companies.

79. *Id.*

80. Thomas et al., *supra* note 51, at 1259.

81. *Id.*

82. *See* Marinilka B. Kimbro & Danielle Xu, Shareholders Have a Say on Executive Compensation: Evidence from Say-on-Pay in the United States 32 (Apr. 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2209936.

83. *Id.*

84. Miller & Assayag, *supra* note 78, at 2.

85. Thomas et al., *supra* note 51, at 1259. Institutional Shareholder Services ("I.S.S.") is the largest and most influential of the proxy advisory firms, which "specialize in advising pension funds and mutual funds, for a fee, how to vote the proxies of the shares held in their investment portfolios." Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1277 (2008).

86. EQUILAR, *supra* note 74. According to the report, all thirty-six companies "made at least one change to their compensation or governance policies in response to the vote" and twenty companies "cited shareholder outreach as an important action to be taken following the vote." *Id.*

and required executives "to hold on to stock options or restricted shares they receive for a year after they are granted."[87] In addition, the company ended its practice of "gross-up," for which severance agreements with executives would force the company to cover their tax bills.[88] Such changes help explain why, of the Russell 3000 companies that failed their 2011 votes, all but four received shareholder approval in 2012.[89]

The vote was an impetus in changing pay policies at companies that did not even fail their vote, as demonstrated by Johnson & Johnson.[90] The company received majority support, but made changes to its pay plan after nearly forty percent of its shareholders voted to reject the plan.[91] Johnson & Johnson made changes to its long-term incentive program for its executives, replacing some cash incentives with stock awards that vest only after three years and after goals related to shareholder returns are met.[92] According to the company's proxy statement, those changes were made "as a result of what [they] learned in 2011."[93] The company eliminated cash payments for long-term incentives, instead awarding "stock units that vest only over three years and after meeting three goals aligned with shareholder returns."[94] Such changes for companies that did not fail their say-on-pay vote provide strong support for the premise that even though there was no major shareholder revolt against executive pay, say-on-pay has had a meaningful impact.

2. *Subsequent Years: 2012–13*

Corporate governance experts believed that it could be more difficult during the 2012 proxy season for executive pay policies to pass muster with shareholders because institutional investors had more opportunity to study pay proposals.[95] This thought seemed to be confirmed when fifty-five percent of Citigroup shareholders voted against the firm's pay package.[96]

87. Gretchen Morgenson, *A Rich Game of Thrones: At Last, Signs That Shareholders Are Making Their Voices Heard*, N.Y. TIMES, Apr. 8, 2012, at BU1.

88. *Id.*

89. The four Russell 3000 companies that failed their say-on-pay vote in both years were Hercules Offshore, Kilroy Realty, Tutor Perini, and Nabors Industries. *See* SEMLER BROSSY, 2012 SAY ON PAY RESULTS: RUSSELL 3000 YEAR-END REPORT 2 (2012) [hereinafter SEMLER BROSSY, 2012 RESULTS]. Kilroy Realty, Nabors Industries, and Tutor Perini have also failed their say-on-pay votes in 2013. SEMLER BROSSY, 2013 SAY ON PAY RESULTS: RUSSELL 3000 YEAR-END REPORT 1 (2013) [hereinafter SEMLER BROSSY, 2013 RESULTS].

90. Dena Aubin & Ross Kerber, *Analysis: Citi's Pay Rejection a Wake-Up Call to Boards*, REUTERS (Apr. 18, 2012, 6:22 PM), http://www.reuters.com/article/2012/04/18/us-citigroup-pay-idUSBRE83H1GC20120418.

91. *Id.*

92. *See id.*; *see also* Morgenson, *supra* note 87.

93. Morgenson, *supra* note 87.

94. *Id.*

95. Aubin & Kerber, *supra* note 90.

96. *Id.*

Shareholders followed the recommendation of the proxy advisory firm I.S.S., which advised shareholder rejection of the company's pay policy due to the size and nature of CEO Vikram Pandit's compensation package.[97] I.S.S. recommended that shareholders vote against Pandit's pay "because parts of his awarded pay were not based on Citigroup's financial performance, Citigroup stock had declined by more than 90 percent in the last five years and Mr. Pandit's pay package was not in alignment with that of his peers."[98] According to Steven Davidoff, Citigroup's "pay vote is likely to invite more federal regulatory scrutiny. It may even push regulators to act given that I.S.S.'s report was quite vocal in asserting that Mr. Pandit's pay was untethered to Citigroup's actual performance."[99] Given the stature of Citigroup, one of the largest financial services corporations in the country, the vote seemed to be the beginning of a shareholder revolt against executive pay.[100]

The shareholder revolt has not yet materialized, however, and the ultimate ramifications of Citigroup's vote are still unclear. Moreover, the voting results of the 2012 and 2013 proxy seasons did not differ substantially from the year before for most Russell 3000 companies. By the end of the year, fifty-seven Russell 3000 companies failed their votes, approximately 2.6% of companies that placed say-on-pay on their ballots.[101] Of the Russell 3000 companies that passed their vote, 73% passed with over 90% shareholder approval and 91% that passed did so with over 70% shareholder approval.[102] The 2013 proxy season had similar results, as 91% of Russell 3000 companies passed their vote with over 70% shareholder approval, and 77% passed with over 90% approval.[103]

Similar to the first year of voting, the subsequent years tended to show overwhelming shareholder support for firms' executive pay packages.[104] But like the 2011 results, the numbers alone do not tell the full story. As was the case in 2011, many companies chose to place more stringent rules on their pay policies prior to voting.[105] For example, companies have begun to place "clawback" clauses into their

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97. Steven M. Davidoff, *Citigroup Has Few Options After Pay Vote*, N.Y. TIMES DEALBOOK (Apr. 12, 2012, 12:38 PM), http://dealbook.nytimes.com/2012/04/18/citigroup-has-few-options-after-pay-vote.

98. *Id.*

99. *Id.*

100. *See* Robert Reich, *Citigroup Shareholders Revolt. Will CEO Pay Drop?*, CHRISTIAN SCI. MONITOR (Apr. 18, 2012), http://www.csmonitor.com/Business/Robert-Reich/2012/0418/Citigroup-shareholders-revolt.-Will-CEO-pay-drop ("Institutional investors are catching on to a truth they should have understood years ago: When executive pay goes through the roof, there's less money left for everyone else who owns shares of the company.").

101. SEMLER BROSSY, 2012 RESULTS, *supra* note 89, at 2.

102. *Id.*

103. SEMLER BROSSY, 2013 RESULTS, *supra* note 89, at 1.

104. *Id.*; SEMLER BROSSY, 2012 RESULTS, *supra* note 89, at 2.

105. *See* Gillian Brianna White, *Results Mixed on Shareholder 'Say on Pay' for Top Executives*, MEDILL REP. (June 7, 2012), http://news.medill.northwestern.edu/chicago/news.aspx?id=206654.

compensation agreements, which allow companies to take back performance or incentive-based pay if an executive does not meet the firm's ethical standards.[106]

Such significant changes to pay packages occurred at prominent companies. Morgan Stanley, which first implemented clawback clauses in 2011, expanded the ways in which those clawbacks could be triggered.[107] The firm now has the ability "to pull back compensation on all long-term incentive payment and executive pay can be taken back or cancelled for additional reasons, including substantial losses and the failure to adequately manage."[108] Yahoo!, as a result of poor say-on-pay results in 2011 and 2012, implemented a new pay program for executives, eliminating minimum funding levels for annual incentives and promoting long-term incentives by providing bonuses based on performance metrics.[109] In 2013, Yahoo! passed its say-on-pay vote with ninety-four percent shareholder approval, which was a substantial increase from 2011 and 2012, when the company received fifty percent and sixty-nine percent approval, respectively.[110] All three years of say-on-pay have resulted in near-universal support for executive compensation packages. However, as the Morgan Stanley and Yahoo! examples suggest, the results have not reflected the significant changes that firms have imposed on executive pay as result of say-on-pay.

3. Implications of the Voting Results

The results of say-on-pay voting have so far indicated that shareholders are taking their votes seriously. The first empirical study of say-on-pay, by Marinilka Kimbro and Danielle Xu, describes that the first two years of mandatory say-on-pay "show a great degree of shareholder sophistication in recognizing the monitoring and reward tools that need to coexist between owners and firm managers."[111] In reviewing say-on-pay votes for Russell 3000 companies in 2011 and 2012, Kimbro and Xu found that failed votes were often associated with poor firm performance and abnormal compensation policies.[112] The results indicated a "very strong and statistically significant relationship between returns, performance and [say-on-pay] votes" with firms with low returns and returns on assets more likely to fail their vote.[113] With regard to pay (particularly equity compensation as opposed to cash compensation),

106. *Id.*
107. *Id.*
108. *Id.*
109. SEMLER BROSSY, 2013 RESULTS, *supra* note 89, at 2.
110. *Id.*
111. Kimbro & Xu, *supra* note 82, at 10.
112. *Id.* at 23–24.
113. *Id.* at 34.

higher levels of compensation were associated with lower approval votes.[114] Kimbro and Xu conclude that even though say-on-pay was only advisory in nature, the voting results indicated that say-on-pay was effective in improving corporate governance because "shareholders are 'doing their homework' and are carefully discerning and identifying relevant issues that should be linked to executive compensation. . . . [S]hareholders are voting down excessive compensation packages of firms with low returns, high return volatility, poor financial performance and low quality accounting."[115] This suggests that shareholders have begun to take a substantially more active role in the affairs of the firm.

The results also strongly indicate that proxy advisory firms have had a significant influence on shareholders regarding say-on-pay voting. Like the Citigroup situation, proxy advisory firms recommended that shareholders reject pay proposals, and shareholders seemed to follow suit.[116] Even where proxy advisory firms recommended a "no" vote and shareholders ultimately disagreed, the level of shareholder support for pay proposals have been significantly lower.[117] According to one study of the 2012 voting results, when I.S.S. recommends a rejection for a pay proposal, the average shareholder vote has been sixty-five percent in favor; when I.S.S. recommends support, the average approval has been ninety-five percent.[118] Another study concluded that while the evidence has not been found to be either positive or negative for shareholders, it does "clearly show that companies do respond to the [say-on-pay] policies adopted by proxy advisory firms."[119] This is because:

> The majority of companies determine in advance whether their executive compensation programs are likely to receive a favorable recommendation from ISS or Glass Lewis; and companies are likely to make changes to a program in anticipation of a negative recommendation from these firms. All areas of the compensation program are affected, including disclosure, guidelines, and plan structure and design.[120]

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114. *Id.*

115. *Id.* at 4, 10.

116. *See* Nell Minow, *More Shareholders Are Just Saying No on Executive Pay*, BLOOMBERG (July 19, 2012, 3:30 PM), http://www.bloomberg.com/news/2012-07-19/more-shareholders-are-just-saying-no-on-executive-pay.html (stating that of the first fifteen firms that failed their say-on-pay vote, fourteen were also subject to recommendations to vote no by I.S.S.).

117. *Id.*

118. John D. England, *Say on Pay Soul Searching Required at Proxy Advisory Firms*, PAY GOVERNANCE (June 20, 2012), http://paygovernance.com/say-on-pay-soul-searching-required-at-proxy-advisory-firms. The 2011 results were less pronounced: when I.S.S. recommended that shareholders decline a proposal, the average vote was seventy percent in favor; when I.S.S. recommended a proposal, the average vote was ninety-five percent in favor. *Id.*

119. David F. Larcker et al., *The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions*, DIRECTOR NOTES, Mar. 2012, at 6.

120. *Id.*

As discussed below,[121] the emergence of these firms in recent years has helped to substantially transform the role of shareholders and shareholder votes in corporate governance.[122]

To summarize, the first three years of say-on-pay, while not having the effect of lowering executive pay, have shown that shareholders can be influential in the decisionmaking process regarding executive pay. However, shareholders armed with say-on-pay voting have few options if the directors choose to ignore a failed say-on-pay vote. In terms of litigation, at least one putative class action has been filed against a corporation for failing to adequately disclose executive pay matters in proxy statements.[123] Part IV examines the shareholder derivative suit, which shareholder plaintiffs have frequently used against corporations in connection to failed say-on-pay votes.

IV. Say-on-Pay and Shareholder Derivative Suits

The first few years of say-on-pay have demonstrated that shareholders can have a meaningful impact on executive compensation. Shareholders have few methods of recourse, however, in the event that a corporation chooses to ignore shareholder input because shareholders generally do not have sufficient power to influence corporations and their boards. Shareholders have recently resorted to litigation in order to hold corporations that fail their say-on-pay votes accountable.[124] This Part examines shareholder derivative suits, which allow shareholders to compel the corporation to sue directors who breach their fiduciary duties. In the context of say-on-pay, shareholders can sue directors who breach their fiduciary duties by disregarding failed votes and refusing to modify executive compensation packages.[125] However, derivative suits have stringent pleading standards, and as discussed below, shareholders in say-on-pay suits have struggled to get past the pleading stage.

A. Background on Shareholder Derivative Suits

The main rationale for the development of shareholder derivative suits is the central tenet that the directors, and not the shareholders, manage the corporation.[126] As such, the directors have a fiduciary duty to

121. *See infra* Part IV.C.

122. *See, e.g.*, Versata Enters., Inc. v. Selectica, Inc., 5 A.3d 586, 602 (Del. 2010); Yucaipa Am. Alliance Fund II v. Riggio, 1 A.3d 310, 355 (Del. Ch. 2010); Stephen J. Choi et al., *Director Elections and the Role of Proxy Advisors*, 82 S. Cal. L. Rev. 649, 696–97 (2009).

123. *See, e.g.*, Morrison v. Hain Celestial Grp., Inc., 971 N.Y.S.2d 391 (N.Y. Sup. Ct. 2013).

124. Thomas et al., *supra* note 51, at 1262 ("Fear of litigation following a failed say-on-pay vote has led corporate advisers to recommend that firms change the CEO performance evaluation process, thus positioning the company to avoid a negative vote or to defend against such a lawsuit.").

125. *Id.* at 1261.

126. *See, e.g.*, Del. Code Ann. tit. 8, § 141(a) (2013) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors.").

the corporation and its shareholders, requiring "an undivided and unselfish loyalty to the corporation [that] demands that there shall be no conflict between duty and self-interest."[127] To provide a method of redress for shareholders against a disloyal board, the "derivative action developed in equity to enable shareholders to sue in the corporation's name where those in control of the company refused to assert a claim belonging to it."[128]

A derivative suit enables a shareholder to sue a third party on behalf of the corporation.[129] As the real party of interest in a derivative suit, any monetary recovery from the suit is directed toward the corporation.[130] Thus, shareholders can benefit indirectly from their ownership stake in the corporation.[131] Shareholders file a derivative suit in order "to protect their long-term interest in the company by imposing corporate governance and management changes."[132]

The derivative suit is not an all-powerful tool for shareholders, however. The ability to bring a derivative action "is limited to situations where either the stockholder has demanded the directors pursue a corporate claim and the directors have wrongfully refused to do so, or where demand is excused because the directors are incapable of making an impartial decision regarding whether to institute such litigation."[133] The demand requirement is based on the recognition that the directors manage the corporation, and the "very nature [of] the derivative action impinges on" the directors' ability to do so freely.[134] Thus, the requirement "exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits."[135] Plaintiffs generally plead demand futility because to make a demand on the board would cede control of the suit, and thus its fate, to the board.[136] After the plaintiff makes a demand, the board

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127. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

128. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

129. *Id.*

130. *See* Ross v. Bernard, 396 U.S. 531, 538 (1970) ("The corporation is a necessary party to the action; without it the case cannot proceed. Although named a defendant, it is the real party in interest, the stockholder being at best the nominal plaintiff.").

131. Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 NOTRE DAME L. REV. 75, 81 (2008).

132. William Alan Nelson II, Esq., *Ending the Silence: Shareholder Derivative Suits and Amending the Dodd-Frank Act so "Say on Pay" Votes May Be Heard in the Boardroom*, 20 U. MIAMI BUS. L. REV. 149, 157 (2012).

133. Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 366–67 (Del. 2006).

134. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

135. *Id.* at 811–12. A strike suit is typically "a securities fraud suit or shareholder derivative action brought without a good faith belief in prevailing on the merits and advanced only for settlement value." Christopher M. Fairman, *Heightened Pleading*, 81 TEX. L. REV. 551, 564 n.111 (2002).

136. Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L. Q. 569, 576–77 (2001).

often moves to dismiss the suit "and, if the board appears to have acted independently and to have conducted a reasonable investigation of the allegations in the plaintiff's complaint, a court will generally grant this motion."[137]

Excusing demand, also known as demand futility, is an exceptionally difficult task for shareholders. Plaintiffs must be able to plead with particularity why demand would have been futile.[138] Where there are allegations that the directors made a conscious business decision in breach of their fiduciary duties, as is the case if a say-on-pay vote has been ignored, plaintiffs must typically satisfy the test established by the Delaware Supreme Court in *Aronson v. Lewis*.[139] This "requires that the plaintiff allege particularized facts creating a reason to doubt that '(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.'"[140] To make matters more difficult more for plaintiffs, they must satisfy this burden "without the benefit of discovery."[141]

In order to show that a director is "interested," the plaintiff must allege with particularity that the director "will be materially affected, either to his benefit or detriment, by a decision of the board, in a manner not shared by the corporation and the stockholders."[142] To show that a director lacks independence, the plaintiff must also allege with particularity that the director cannot "base his decision 'on the corporate merits of the subject before the board rather than extraneous considerations or influences.'"[143] To satisfy the first prong of the *Aronson* test in a derivative suit challenging executive compensation, "[t]he plaintiff's best hope is to show that a majority of the board of directors is financially interested in the compensation decision."[144] However, it is

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137. *Id.*

138. *See* Fed R. Civ. P. 23.1(b)(3) (the plaintiffs must "state with particularity: (A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and (B) the reasons for not obtaining the action or not making the effort"); *see also* Del. Ch. Ct. R. 23.1(a) (2013) ("The 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."). Courts apply the requirements of demand futility as established by the law of the state of incorporation. Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 108–09 (1991). Hence, Delaware law is often applied in derivative suits in both federal and state courts, including outside of Delaware.

139. *See* Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984); Wood v. Baum, 953 A.2d 136, 140 (Del. 2008); *see also* RCM Sec. Fund, Inc. v. Stanton, 928 F.2d 1318, 1330 (2d Cir. 1991) (applying the *Aronson* test).

140. *Wood*, 953 A.2d at 140 (quoting *Aronson*, 473 A.2d at 814). The plaintiff may satisfy either prong of the *Aronson* test to establish demand futility. Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).

141. Thomas & Martin, *supra* note 136, at 587.

142. Seminaris v. Landa, 662 A.2d 1350, 1354 (Del. Ch. 1995) (citing Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993)).

143. *Id.* (quoting *Aronson*, 473 A.2d at 816).

144. Thomas & Martin, *supra* note 136, at 577.

extremely unlikely that a plaintiff can successfully make this showing. This is because "[m]any public corporations have compensation committees comprised mostly, if not exclusively, of disinterested outside directors. The effect of such a committee is that it will often erect an unsurpassable barrier in the plaintiff's quest to challenge executive compensation."[145]

To satisfy the second prong of the *Aronson* test, the plaintiff's allegations must be able to rebut the business judgment rule. The business judgment rule "is 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."[146] A plaintiff can rebut the business judgment rule "by alleging with particularity that a director *knowingly* violated a fiduciary duty or failed to act in violation of a *known* duty to act, demonstrating a *conscious* disregard for her duties."[147] Alternatively, the plaintiff can rebut the presumption by placing into doubt that the directors' decisions were made as part of a rational decision, in which they "availed themselves of all material and reasonably available information."[148]

Rebutting the business judgment rule provides shareholder plaintiffs the strongest approach in incorporating say-on-pay votes into their complaint. The votes represent the desire of the shareholders to whom directors owe a fiduciary duty of loyalty, and failure to consider voting results strongly suggests that the directors failed to avail themselves of material and reasonably available information. This Part focuses on plaintiffs' ability to use a failed say-on-pay vote to support demand futility. Due to the advisory nature of a say-on-pay vote, however, courts have been reluctant to conclude that the directors' failure to consider a negative say-on-pay vote amounts to the directors consciously disregarding their fiduciary duties.

B. Results of Say-on-Pay Derivative Suits

So far, shareholders have brought a handful of derivative suits against the board of directors, senior executives, and compensation consultants over failed votes.[149] The suits allege "that the 'No' votes reflected the 'independent business judgment' of shareholders that the pay was not in the interest of their firms and they attacked the compensation decisions as breaches of the duties of loyalty and good faith owed by corporate

145. *Id.* at 577–78 (quotation marks omitted).
146. *Aronson*, 473 A.2d at 812.
147. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 125 (Del. Ch. 2009).
148. *Id.* at 124; *see* Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000) ("The Board is responsible for considering only material facts that are reasonably available, not those that are immaterial or out of the Board's reasonable reach." (emphasis omitted)).
149. Nelson II, *supra* note 132, at 156.

officials to their shareholders."[150] So far, only one suit has managed to survive a motion to dismiss.[151]

1. Cincinnati Bell

In *NECA-IBEW Pension Fund ex. rel. Cincinnati Bell, Inc. v. Cox*, the board of directors approved pay raises and bonuses for its top three executives in 2010 despite the company suffering "a $61.3 million dollar decline in net income, a drop in earnings per share from $0.37 to $0.09, a reduction in share price from $3.45 to $2.80, and a negative 18.8% annual shareholder return."[152] After approving the package, the directors sought shareholder approval of the 2010 compensation package in its 2011 proxy.[153] Subsequently, approximately two-thirds of the voting shareholders rejected the 2010 package in the proxy vote.[154] Citing this overwhelming rejection of the compensation package, the plaintiffs filed a derivative suit alleging that the board breached its fiduciary duty of loyalty when it approved pay raises and bonuses for company executives in a year for which the company performed dismally.[155]

The Ohio district court denied the defendants' motion to dismiss, determining that the plaintiffs sufficiently alleged demand futility as well as claims for breach of fiduciary duty and unjust enrichment.[156] With regard to demand futility, the court found that:

> Given that the director defendants devised the challenged compensation, approved the compensation, recommended shareholder approval of the compensation, and suffered a negative shareholder vote on the compensation, plaintiff has demonstrated sufficient facts to show that there is reason to doubt these same directors could exercise their independent business judgment over whether to bring suit against themselves for breach of fiduciary duty in awarding the challenged compensation.[157]

Accordingly, the court held that a failed say-on-pay vote was sufficient to rebut the business judgment rule. However, as discussed below, courts have overwhelmingly rejected the analysis in *Cincinnati Bell*.

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150. Daniel J. Morrissey, *Executive Compensation and Income Equality*, 4 WM. & MARY BUS. L. REV. 1, 29 (2013).
151. NECA-IBEW Pension Fund *ex rel.* Cincinnati Bell, Inc. v. Cox, No. 1:11-451, 2011 WL 4383368, at *5 (S.D. Ohio. Sept. 20, 2011).
152. *Id.* at *1.
153. *Id.*
154. *Id.*
155. *Id.*
156. *Id.* at *3–5.
157. *Id.* at *4.

2. *Plaintiffs' Lack of Success in Other Cases*

In most other cases, plaintiffs have failed to survive the motion to dismiss stage.[158] Courts have focused on the advisory nature of the statutory language of Dodd-Frank that expressly states that the vote does not create a fiduciary duty on the directors, with one court stating:

> Under Dodd-Frank, the Board had no obligation to reevaluate its executive compensation plan in light of the shareholders' vote. Additionally, Dodd-Frank explicitly prohibits construing the shareholder vote as "overruling" the Board's compensation decision. Accordingly, the Board's failure to change course in light of the say-on-pay vote does not give rise to a substantial likelihood of personal liability, nor demonstrate that the Board would have been unable objectively to evaluate a demand to bring suit.[159]

As such, courts have consistently determined that a failed say-on-pay vote *alone* does not rebut the presumption of the business judgment rule that applies to directors' compensation decisions.[160] One court has concluded that "a shareholder vote on executive compensation under the Act has substantial evidentiary weight and *may* be used as evidence by a court in determining whether the second prong of the *Aronson* test has been met."[161] But it is clear from the various courts' decisions that a say-on-pay vote can be utilized only if it is one of a larger body of allegations against a board of directors.

In many cases in which plaintiffs filed derivative suits shortly after the failed vote, courts have routinely concluded that because the vote was not held until after the decision to approve the compensation packages, the directors could not have considered the votes in their

158. *But cf.* Boxer v. Accuray Inc., 906 F. Supp. 2d 1012, 1017 (N.D. Cal. 2012) (granting the plaintiffs' motion to remand the case to state court). Similarly, in *Dennis v. Hart*, No. 11-2271, 2012 WL 33199 (S.D. Cal. Jan. 6, 2012), the district court—while partially dismissing the plaintiff's claim—also granted the plaintiffs' motion to remand. *Id.* at *5.

159. Raul v. Rynd, 929 F. Supp. 2d 333, 346 (D. Del. 2013).

160. *See, e.g.*, Robinson Family Trust v. Greig, No. 5:12-1713, 2013 WL 1943330, at *5 (N.D. Ohio May 10, 2013); Laborers' Local v. Intersil, 868 F. Supp. 2d 838, 849 (N.D. Cal. 2012); Swanson v. Weil, No. 11-2142, 2012 WL 4442795, at *10 (D. Colo. Sept. 26, 2012); Gordon v. Goodyear, No. 12-369, 2012 WL 2885695, at *10 (N.D. Ill. July 13, 2012); Iron Workers Local No. 25 Pension Fund *ex rel.* Monolithic Power Sys., Inc. v. Bogart, No. 11-4604, 2012 WL 2160436, at *4 (N.D. Cal. June 13, 2012); Plumbers Local No. 137 Pension Fund v. Davis, Civ. No. 03:11-633, 2012 WL 104776, at *8 (D. Or. Jan. 11, 2012); Charter Twp. of Clinton Police & Fire Ret. Sys. v. Martin, 162 Cal. Rptr. 3d 300, 313–14 (Cal. Ct. App. 2013); *see also* Weinberg *ex rel.* BioMed Realty Trust, Inc. v. Gold, 838 F. Supp. 2d 355, 361 (D. Md. 2012) (finding that, while "a 'say on pay' vote may be reasonably considered as a factor in the demand futility analysis, it is not conclusive in this case"); Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) ("It is the essence of business judgment for a board to determine if a particular individual warrant[s] large amounts of money, whether in the form of current salary or severance provisions.") (quoting Grimes v. Donald, 673 A.2d 1207, 1217 (Del. 1996)) (internal quotation marks omitted).

161. *Intersil*, 868 F. Supp. 2d at 849. The district court then went on to state, "the shareholder vote *alone* is not enough to rebut the presumption of the business judgment rule. Additional facts are required for plaintiff to raise a reasonable doubt that the decision was not a valid exercise of business judgment." *Id.*

decisionmaking.[162] One court noted that, under Delaware law, plaintiffs could not "us[e] events subsequent to the challenged action to second guess a board's business judgment."[163] More commonly, courts reason that "the outcome of the vote . . . does not suggest that, in making those decisions, the directors failed to act on an informed basis, in good faith, and in the honest belief that the decisions were in [the plaintiff's] best interests."[164] However, such a conclusion directly conflicts with the reasoning set forth in *Cincinnati Bell*.

Courts that dismissed the derivative suits have also made concerted efforts to distinguish *Cincinnati Bell*. One court went so far as to state that "it is unlikely that the case remains viable legal authority."[165] But the primary way that courts have distinguished cases is by noting that *Cincinnati Bell* involved the application of Ohio law, while most other cases applied Delaware law.[166] As one court noted, "[u]nder Ohio law, the business judgment rule is an affirmative defense, not an element of excusing a demand on the Board. . . . As such, courts applying Ohio law do not analyze the business judgment rule at the motion to dismiss stage."[167] This appears to be a somewhat disingenuous way in which courts have distinguished *Cincinnati Bell* because the court there expressly stated that there was "reason to doubt" that the directors could

162. *See, e.g.*, *Davis*, 2012 WL 104776, at *7; *Swanson*, 2012 WL 4442795, at *12; Teamsters Local 237 v. McCarthy, No. 2011-197841, 2011 WL 4836230, at *10 (Ga. Super. Sep. 16, 2011).

163. *Swanson*, 2012 WL 4442795, at *11.

164. *McCarthy*, 2011 WL 4836230, at *10–11.

165. *Davis*, 2012 WL 104776, at *8. The court noted that "*Cincinnati Bell*'s holding was recently called into question in light of the court's apparent lack of subject matter jurisdiction and, as that court found particularly troubling, the plaintiff's failure to disclose contrary authority in response to the court's specific inquiry." *Id.* at *5. Another court observed that the *Cincinnati Bell* court "also relied on the fact that all of the directors were named defendants in the action. The court relied on *dicta* from two Ohio cases suggesting that naming all members of the board of directors as defendants may be sufficient to excuse the pre-suit demand requirement." *Greig*, 2013 WL 1943330, at *6. The *Greig* court concluded that the Ohio Supreme Court would not have found that naming all of the members of a board would be sufficient to excuse the demand requirement in light of existing Delaware law, on which Ohio courts frequently rely in derivative actions. *Id.*

166. *See, e.g.*, Robinson Family Trust v. Greig, No. 5:12-1713, 2013 WL 1943330, at *6 (N.D. Ohio May 10, 2013); Swanson v. Weil, No. 11-02142, 2012 WL 4442795, at *7 (D. Colo. Sept. 26, 2012); Gordon v. Goodyear, No. 12-369, 2012 WL 2885695, at *10–11 (N.D. Ill. July 13, 2012); Iron Workers Local No. 25 Pension Fund *ex rel.* Monolithic Power Sys., Inc. v. Bogart, No. 11-4604, 2012 WL 2160436, at *4 n.44 (N.D. Cal. June 13, 2012). The *BioMed* court applied Maryland law and noted that neither Delaware nor Ohio standards for demand futility were comparable. Weinberg *ex rel.* BioMed Realty Trust, Inc. v. Gold, 838 F. Supp. 2d 355, 361 (D. Md. 2012). The court found that by applying either the Maryland or Delaware standard, it would arrive at the same conclusion despite having different standards for demand futility. *Id.* at 362.

167. *Gordon*, 2012 WL 2885695, at *10–11. The *Cincinnati Bell* court stated that "[w]hen plaintiffs allege a breach of fiduciary duty, the business judgment rule would impose on plaintiffs a burden at trial to present evidence to rebut the presumption the rule imposes. However, plaintiffs are not likewise obligated to plead operative facts in their complaint that would rebut the presumption." NECA-IBEW Pension Fund *ex rel.* Cincinnati Bell, Inc. v. Cox, No. 1:11-451, 2011 WL 4383368, at *2 (S.D. Ohio. Sept. 20, 2011).

have exercised their independent business judgment.[168] But be discussed below, the court used dubious reasoning in considering the say-on-pay vote, and it stands to reason that plaintiffs should not rely on *Cincinnati Bell* to support future actions.

C. Analysis and Recommendations

So far, courts have been unsympathetic to plaintiffs' use of failed say-on-pay votes to rebut the business judgment rule. This does not suggest, however, that the business judgment rule will always protect directors' decisions on executive compensation in the face of a failed vote. Delaware courts have indicated that there are limits to the protection that the business judgment rule provides. Delaware law recognizes that directors "have the authority and broad discretion to make executive compensation decisions."[169] However, that discretion "is not unlimited. Indeed, the Delaware Supreme Court was clear when it stated that 'there is an outer limit' to the board's discretion to set executive compensation, 'at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste.'"[170] Courts, then, should consider a say-on-pay vote as an effective means of preventing boards from abusing their discretion in setting compensation packages.

A failed say-on-pay vote, particularly a vote that relied on a proxy advisor's recommendation to reject a board's pay proposal, should be sufficient to rebut the business judgment rule and excuse pre-suit demand for a derivative suit. Proxy advisors are able to aggregate information that investors find important in determining how to vote.[171] In determining recommendations for say-on-pay votes, I.S.S. examines "CEO pay and performance; problematic pay practices; communication and responsiveness to shareholders; the performance metrics used in incentive plans; the use of peer groups in benchmarking executive pay; and the balance of performance and non-performance-based pay."[172] This indicates that shareholders rely on a wealth of information in making their vote, and when they vote against the directors' pay

168. *Cincinnati Bell*, 2011 WL 4383368, at *4.

169. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 138 (Del. Ch. 2009).

170. *Id.* (quoting Brehm v. Eisner, 746 A.2d 244, 262 n.56 (Del. 2000)).

171. *See* Choi et al., *supra* note 122, at 696–97.

172. Larcker et al., *supra* note 119, at 2 (citing *Institutional Shareholder Services 2011 Voting Policies*, Institutional Shareholder Services, http://www.issgovernance.com/policy/2011/policy_information (last visited Apr. 24, 2014). Glass Lewis, another proxy firm considers the following in making their recommendations: "[T]he overall design and structure of the company's executive compensation program, including performance metrics; the quality and content of the company's disclosure; the amount paid to executives; and the link between compensation and performance as indicated by the company's current and past pay-for-performance grades." *Id.*

proposal, they do so based on information that is "material and reasonably available" to the directors.[173]

This does not mean that a failed say-on-pay vote should always be considered sufficient to establish demand futility. In fact, the cases so far in which the courts dismissed for failure to establish demand futility came to the correct conclusion. The *Cincinnati Bell* court stated that because the directors submitted their executive pay proposal to vote and asked for shareholder support, and subsequently saw their proposal rejected by the shareholders, "there is reason to doubt these same directors could exercise their independent business judgment over whether to bring suit against themselves for breach of fiduciary duty in awarding the challenged compensation."[174] But this cannot be the case. Although directors may not have been able to exercise their business judgment in considering the "no" vote, they also did not have the opportunity to do so. Thus, shareholders are not suing because the directors failed to exercise their business judgment; rather, they are suing based on the benefits of hindsight. Shareholders should only be able to use say-on-pay votes as the basis of demand futility when at least one of two criteria are present: (1) particularized allegations that there was dialogue between directors and shareholders after the failed vote, and the directors then chose to ignore shareholder input; or (2) a second consecutive failed vote, which provides strong evidence that the directors deliberately ignored shareholders in choosing to approve a pay proposal.

Still, there are institutionalized obstacles that inhibit courts' ability to consider the say-on-pay votes at the motion for dismissal stage. Courts have generally been reluctant to intervene in executive compensation disputes, citing concerns about lack of competence to consider compensation decisions.[175] But as some commentators have noted, such concerns have little empirical support as courts regularly determine complex issues, including those in corporate law.[176] And as demonstrated in *Brehm v. Eisner*, courts have shown willingness to scrutinize directors' decisions on compensation when executive pay pushes toward excessive

173. *In re Citigroup*, 964 A.2d at 124.

174. *Cincinnati Bell*, 2011 WL 4383368, at *4.

175. *See* Thomas & Martin, *supra* note 136, at 601–02. Thomas and Martin summarized the argument as follows: "Boards of directors are better suited than courts for making determinations about the appropriate levels of executive compensation. Directors are more knowledgeable than judges about their companies' needs and the market for executive talent. They, not the courts, should be responsible for determining the pay levels of officers." *See id.* at 602; *see also* BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 16, at 45 ("Courts are simply ill equipped to judge the desirability of compensation packages and policies.").

176. *See, e.g.*, BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 16, at 45; Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1896 n.79 (1992) (reviewing GRAEF CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES (1991)).

levels.[177] To the contrary, courts are perhaps "best positioned to police abuses of the executive compensation process."[178]

Accordingly, courts should apply stricter standards of judicial review when directors ignore failed say-on-pay votes.[179] Where a shareholder's complaint alleges demand futility on the basis of a failed vote, the burden should be placed on the board to show that they properly considered the vote and its implications. If the board declined to take shareholder's input into account in a subsequent pay proposal, then the board must be able to show that executives were compensated reasonably. The board may provide evidence that compares the pay proposal to other compensation packages paid out to executives at comparable corporations. The board may also show evidence that the pay was justified on the basis of the executives' job performance. Absent such a showing, courts should deny the board's motion to dismiss.

At least one Delaware chancellor has suggested that the Delaware courts should apply enhanced scrutiny in such situations.[180] However, that same chancellor had strong concerns that such a new standard of review would result in a revolt against the courts that occurred as a result of *Smith v. Van Gorkom*,[181] the infamous case that enabled directors to

177. Brehm v. Eisner, 746 A.2d 244, 249 (Del. 2000). In *Brehm*, plaintiffs brought a breach of fiduciary duty claim against the board of directors at the Walt Disney Company for approving an "extravagant and wasteful" compensation package for former president of the company, Michael S. Ovitz. *Id.* at 248–49. As president of Disney, Ovitz was paid "a base salary of $1 million per year, a discretionary bonus, and two sets of stock options . . . that collectively would enable Ovitz to purchase 5 million shares of Disney common stock." *Id.* at 250. Additionally, Ovitz would be paid $10 million if Disney declined to retain him at the end of his five-year term. *Id.* If Ovitz was terminated without cause—that is, he did not resign voluntarily or commit gross negligence or malfeasance—Ovitz would be paid the remainder of his salary owed to him at the end of the five-year term, an additional "$10 million severance payment, an additional $7.5 million for each fiscal year remaining under the agreement, and the immediate vesting of the first 3 million stock options." *Id.* According to the Delaware Supreme Court, "the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious, compared to Ovitz's value to the Company; and . . . the processes of the boards of directors in dealing with the approval and termination of the Ovitz Employment Agreement were casual, if not sloppy and perfunctory." *Id.* at 249. The court went on to note that "the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions." *See id.*; *see also* Thomas & Wells, *supra* note 30, at 876–77 (citing *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003)) (arguing that the chancery court's ruling on remand "could be read to mean that directors who knowingly acted without adequate information and deliberation in approving an executive compensation package had failed to satisfy their fiduciary duty to act in good faith").

178. Thomas & Martin, *supra* note 136, at 604.

179. Many commenters have argued for enhanced scrutiny in cases involving executive compensation. *See, e.g.*, *id.* at 603–05; Yablon, *supra* note 176, at 1899–1900; Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 252–61 (1983).

180. *See* Gordon Smith, *The Business Associations Section*, CONGLOMERATE (Jan. 6, 2012), http://www.theconglomerate.org/2012/01/the-business-associations-section.html.

181. *Id.*

be liable for monetary damages even where they acted in good faith.[182] Therefore, one commentator opined that the likelihood of Delaware courts doing so was unlikely "absent a big shift in the debate on executive compensation."[183]

A *Van Gorkom*-like revolt would likely not occur here. In the past, courts have applied heightened scrutiny to consider directors' decisions on executive compensation with little fanfare.[184] In addition, fears that added scrutiny after a failed say-on-pay vote will lead to a sharp rise in litigation have little support.[185] As previously noted, only four companies have so far had two consecutive failed votes. The incentive for directors to respond after a vote, in order to appease shareholders and mitigate the consequences of public scrutiny, is too great. Further, the derivative suits that would actually be decided on the merits will allow courts to develop a set of best practices that would better guide companies on how to properly respond after a failed vote to avoid potential litigation.[186]

While the potential of an increase in frivolous litigation should be a concern, the increase of litigation is not necessarily a problem. The threat of lawsuit, especially one that could be decided on the merits, provides a strong incentive for directors to carefully consider a failed say-on-pay vote. As Yablon noted, "[m]ost legal regulation of corporate behavior does not take place in court, but in lawyers' offices, as corporate lawyers counsel their clients as to what they must do to avoid legal 'problems' in connection with the actions they want to take."[187] And in "the area of executive compensation, increased litigation risk may have the salutary

182. In *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), the Supreme Court of Delaware held that Trans Union's directors were grossly negligent in breaching their duty of care when they failed to consider the CEO's merger proposal. *Id.* at 881. In so doing, the court required directors to fully assess information prior to making decisions in their fiduciary capacity; otherwise directors could be found to be violating their duty of care, regardless of whether they acted in good faith. *Id.* at 872–73. The result significantly increased the risk of liability for directors, prompting insurance companies to raise corporate insurance rates. Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 466 n.58 (2004). "Corporate lawyers and managers also complained loudly and the specter of a crisis in quality board directors emerged." *Id.*; *see* Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. L. 1437, 1455 (1985) (referring to *Van Gorkom* as "one of the worst decisions in the history of corporate law"). As a direct result of the case, "the Delaware legislature amended the Delaware General Corporation Law to allow for an optional charter provision to exculpate directors for violations of the duty of due care." Sale, *supra* note 182, at 466 (citing DEL. CODE ANN. tit. 8, § 102(b)(7) (2012)); *see also* Stephen A. Radin, *The Director's Duty of Care Three Years After* Smith v. Van Gorkom, 39 HASTINGS L.J. 707, 747–48 (1988) (finding that by the end of 1987, twenty-seven states enacted statutes modeled after section 102(b)(7)).

183. *See* Smith, *supra* note 180.

184. Thomas & Wells, *supra* note 30, at 880.

185. *See* Yablon, *supra* note 176, at 1901 (explaining that litigation challenging executive compensation "is likely to involve rather uncertain and fairly low damages").

186. *See* Thomas & Wells, *supra* note 30, at 895 (noting that during the 1980s and 1990s, courts "developed special procedures for boards to follow when selling companies to managers or controlling shareholders").

187. Yablon, *supra* note 176, at 1897.

effect of giving corporate counsel greater incentive to restrain executive overcompensation."[188] Thus, litigation merely enforces the purposes of say-on-pay by providing shareholders a forum to express their opinions on a company's pay policies through voting and inducing directors to practice restraint when determining and approving executive pay packages.

Conclusion

Since say-on-pay voting became mandatory in 2011, the voting results have not shown a major upheaval in executive pay, as some had hoped. However, the first three years of say-on-pay, while not yet impacting the *amount* that executives are paid, have suggested that shareholders have had a significant effect on *how* executives are paid. Moreover, the first three years of voting have strongly indicated that shareholders are taking their votes seriously and companies are listening to their shareholders on pay matters. However, due to the advisory nature of the vote, say-on-pay does not provide shareholders with any effective means of recourse when directors fail to consider the shareholders' votes, thereby limiting the effectiveness of say-on-pay in the long term. In order to strengthen shareholders' ability to bring suits against directors, and therefore make say-on-pay a more effective mechanism in controlling executive compensation, courts should apply a higher standard of scrutiny when considering a failed vote in derivate suits.

188. *Id.* at 1902.

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