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Inside the Boardroom: Responding to a Negative Say on Pay Vote

When stockholders deliver a negative vote on say on pay, directors face the question whether to change corporate policy in response – even if their best business judgment tells them that existing compensation programs are well-designed and are working well. In fact, a negative vote on say on pay does not change the board's fiduciary duty to implement compensation policies that the directors believe are the best way to attract, retain and incentivize top-quality managers:

- The law is clear in all American jurisdictions that setting compensation policy and structuring compensation agreements are decisions reserved for directors and not shareholders. That is why say on pay resolutions are advisory and do not carry mandatory force.
- Dodd-Frank does not affect this basic legal principle. It specifically provides that say on pay votes do not change the board's fiduciary duties and traditional powers in this area.
- Directors face no prospect of legal liability if they decide to act in a manner contrary to a negative say on pay vote. Indeed, courts have recognized that when a board acts after internal corporate debate, in which differing viewpoints are fully canvassed, the board's ultimate decision is due even more deference than is ordinarily the case.
- Following a negative say on pay vote, scrutiny of director decision-making will be increased. The compensation committee should act with the advice of an independent compensation consultant, and should address itself to the arguments advanced by the proponents of a "no" vote. In this context, it supports a board's decision to reject the reasoning of the proponents of a negative outcome that at least some institutions voted in accord with the board's recommendation. If a Board follows appropriate procedure in determining not to revise compensation that was the subject of a negative say on pay vote, there will be no legal liability and the board need have no concern about litigation.

The need for directors to make their own independent judgments about executive compensation is further borne out by the dynamics of the overall debate on executive compensation. Specifically:

- A negative say on pay vote will often be due to shareholders voting automatically in accord with ISS recommendations, rather than independent voting by review by institutions. A board is justified in viewing a stockholder vote flowing from rote reliance on an ISS determination as presenting a less than compelling case for overriding directors' business judgment. It is reasonable to think that if institutional investors strongly supported executive compensation changes as a result of their own independent analysis, they would communicate directly with the company on that issue.
- There is no credible evidence that ISS compensation metrics and recommendations have actually created value for shareholders. ISS has itself published no evidence demonstrating the creation of such value. A recent Stanford University study demonstrates that ISS voting recommendations on employee stock option exchanges do not increase, and in fact actually decrease, shareholder value. ISS itself (in contrast to directors) has no fiduciary duty to shareholders or corporations.

Despite the new say on pay regime, there is no reason to change the long-standing law and practice recognizing that boards are best qualified to decide what corporate policies are needed to attract, retain and incentivize management. If compensation committees and compensation consultants modify or abandon compensation plans they believe are best suited to meet the companies' objectives solely in order to make them compliant with ISS guidelines and avoid a negative say on pay recommendation, they will have abdicated their respective fiduciary duties and professional duties.

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