December 23, 2008

CORPORATE ALERT

TOP 10 TOPICS FOR DIRECTORS IN 2009

It's hard to believe that a year has already passed since we last published our top 10 topics for directors. And what a year it has been! With the financial landscape of America forever changed, and the economy sinking further into recession, here is our list of hot topics that directors will be focusing on in 2009:

1. Overseeing the development and implementation of corporate strategy as companies face extraordinary challenges to survive.

2. Overseeing enterprise risk management, which includes all facets of a company's risk profile, including operational, financial, strategic, compliance and reputational risks.

3. Cultivating shareholder relations while preparing for a hostile proxy season.

4. Shoring up takeover defenses where depressed share prices have made companies vulnerable to hostile bids.

5. Setting appropriate executive compensation in the midst of public outcry over excessive pay packages.

6. Making sure that an effective succession plan is in place.

7. Monitoring and responding to the significant changes that the actions of the Obama administration and Congress will have on American business.

8. Dealing with increasing pressures from investors and regulators to curb carbon emissions and provide more disclosure about climate change.

9. Preparing for increasing litigation in a down economy and more government investigations.

10. Making sure that their companies' indemnification arrangements and D&O insurance are up to date and provide adequate protection.

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DISCUSSION

1. Circle the Wagons: Strategic Planning Challenges in 2009

Probably the most important and challenging function of the board of directors is overseeing the development and implementation of corporate strategy. This task will be even more daunting in the coming year, as companies of all types and sizes are forced to rethink their business plans in light of almost daily shocks to the financial markets and a deepening recession. In these difficult and rapidly changing times, directors will need to devote substantial attention to probing and gauging the effectiveness of management's strategic plans for the company. There are several key areas that directors will be focusing on:

- ***Survival*.** Simply surviving the current downturn is first and foremost on the minds of most companies. Directors need to be satisfied that management is taking appropriate and timely steps to address the effect of the deteriorating economy on the company's prospects. Directors need to be comfortable with the assumptions management is using in developing cost-cutting strategies, whether those measures entail closing plants, laying off workers, slashing inventory, shelving capital projects or shedding non-earning assets. Given the increasing number of doomsday predictions of a deep and prolonged recession, directors also need to press management for its contingency plans for dealing with a "worst case" scenario.

- ***Liquidity and Financial Condition*.** In most recessions, cash is king. This adage could not be more true in the current business climate, as credit markets remain frozen despite massive government efforts to defrost them. Directors need to understand the effects of the credit crisis and the battered economy on the company's liquidity position, including projected cash flow, access to sources of capital and contingency planning.

Shoring up the balance sheet is another priority at most companies. Addressing debt coming due during 2009 will be particularly challenging as the frozen credit markets have practically closed the door on several traditional sources of financing. During November, not a single high yield bond deal was completed in the United States, and a paltry $17 billion in leveraged loans were sold, well below the $77.4 billion sold in the same period in 2007.[1] Investment-grade debt also remains expensive, with spreads above Treasurys often exceeding five percentage points.[2] Locked out of the credit markets, many companies are being forced to resort to the equity markets to raise capital, even though low stock valuations make this option unattractive. In addition to traditional stock offerings, companies are turning to PIPEs and rights offerings to raise cash. With varying degrees of success, companies are also using exchange offers with existing debt holders to reduce debt, extend the weighted-average maturity of their debt portfolios or obtain more favorable terms.

With more than $800 billion of corporate debt coming due in 2009,[3] even many healthy companies will face extraordinary refinancing challenges in the coming year. Directors need to understand what steps management is taking to address the company's debt needs, including the likelihood of covenant defaults under various scenarios, plans for renegotiating or refinancing any troubled or maturing debt and contingency planning in the event those options are not available.

- *Opportunities*. While most companies are hunkering down to ride out the recession, they also need to keep an eye out for opportunities that may arise. Recessions often present unique opportunities to increase market share by picking up new customers from rivals going out of business, buying assets at distressed prices, adding talent from

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companies laying off workers or acquiring companies struggling to survive. Sometimes the opportunities can reshape the competitive landscape of an industry, as was the case with Bank of America's acquisition of Merrill Lynch and JP Morgan's purchase of Bear Stearns.[4]

While there might be plenty of bargains out there, finding funding for them is another matter. There is no relief in sight for M&A financing, with November being the worst month for announced deals in 13 years.[5] Even private equity buyers who are flush with cash continue to sit on the sidelines because they still need leverage to make their deals work. Private equity buyout volume is down a whopping 78 percent compared to last year.[6] Nevertheless, PE firms continue to rake in cash, raising 36 percent more during the first nine months of 2008 than they did in the same period last year.[7] Until the credit markets thaw, PE firms are focusing on smaller acquisitions that require lower levels of debt, add-on acquisitions and corporate partnering opportunities where they take minority equity stakes in companies seeking funding for growth.[8] With the tight credit markets, companies are also increasingly using their own stock as currency for acquisitions. All-stock deals accounted for a quarter of M&A deals during 2008, up from just 10 percent in 2007.[9] While companies may be reluctant to use their battered stock for acquisitions, on a relative scale it may not matter, since, in many instances, the target's stock price has fallen just as badly, if not more.

- *Reassessing the Corporate Mission***.** While most companies have their hands full dealing with the day-to-day fallout from the financial crisis and the battered economy, management and the board also need to take a step back and assess whether the unprecedented events of the past year require fundamental changes to the company's strategic direction. Although the credit markets eventually will thaw and the economy will recover, conditions are not expected to improve any time soon, and when they do, we will not see a return to the loose lending standards and easy money that marked the earlier part of this decade. In the new world order, risk will be priced higher, leverage will be less tolerated, government regulation will be more pervasive and the American consumer, who, until now, accounted for 70 percent of U.S. gross domestic product, will spend less. The financial meltdown and ensuing global economic crisis have also exposed companies to a whole catalog of risks they never even knew that they had. Companies need to take a hard look at the lasting impact that these events will have on the viability of their business models and begin the difficult process of making necessary adjustments. As part of this process, boards may find that they need to alter their own composition and committee structure to address the new challenges (and potential opportunities) facing their companies. In working through this process, it will be impossible for the board to make informed decisions about the company's strategic direction without a full understanding of the risks involved. This leads us to our next hot topic.

2. Risk Management

Risk management will take center stage in boardrooms during 2009. Directors ranked risk management as one of their top concerns, according to two recent surveys of public company directors,[10] and audit committee members overwhelmingly consider risk management to be the most challenging issue they are facing.[11] These results are not surprising. According to a recent global survey, over 70 percent of financial services executives believe that the losses stemming from the credit crisis were largely due to failures to address risk management issues.[12] As the fallout from the financial crisis spreads to the broader economy, almost all companies are struggling to get a better handle on their risks.

Enterprise risk management (ERM) is the current buzzword applied to a top-down holistic approach to risk management. It addresses all of an enterprise's risks—including operational, financial, strategic, compliance and reputational risks—under one umbrella, in contrast to the more traditional "silo" approach in which each operating

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function or division tackled risk independently. ERM is not focused simply on risk reduction. Rather, it encompasses an assessment of both upside and downside risks and, thus, helps inform the strategic planning process. There are several frameworks available to assist companies in implementing ERM.[13]

While financial institutions and insurance companies are already familiar with ERM, a recent survey revealed that only about 60 percent of public companies currently have a top-down, enterprise-wide risk management program in place, and that at least 28 percent of these would have received a "weak" rating if a rating agency were to rate the program.[14]

Several factors, in addition to the problems highlighted by the financial crisis, are driving directors to take a more active role with respect to risk management:

- *Fiduciary duties*. As part of their basic fiduciary duties, directors have a duty of oversight that requires them to implement and oversee the operation of reasonable information and reporting systems designed to inform them of material risks.[15] They are also required when making business decisions to act on an informed basis and in good faith. All of this means that directors must be comfortable that (1) their company has in place an effective process to identify, assess and manage risks, (2) the company's risk appetite is appropriate relative to its objectives and (3) the board is receiving sufficient information about the company's material risks and the steps being taken to manage those risks.[16]

- *SEC requirements*. The Sarbanes-Oxley Act requires public companies to assess the effectiveness of their internal control over financial reporting and maintain disclosure controls and procedures. In addition, SEC rules adopted in 2005 require companies to disclose in their annual reports on Form 10-K all material risks and to disclose any material changes to those risks in a Form 10-Q.

- *Stock exchange requirements*. NYSE listing standards require audit committees to discuss the company's guidelines and policies regarding risk assessment and risk management, as well as the company's major financial risks and the steps management has taken to monitor and control those risks.

- *Federal Sentencing Guidelines*. Under federal sentencing guidelines, a business organization can reduce potential penalties (and perhaps avoid prosecution altogether) for wrongdoing if the organization can demonstrate that it had an effective compliance program. The guidelines were amended in 2004 to require that directors exercise reasonable oversight over the implementation and effectiveness of the compliance program to ensure that it is generally effective in preventing and detecting criminal conduct. The guidelines also specifically require that directors receive appropriate training as to their roles and responsibilities.

- *Rating agencies*. The rating agencies are stepping up pressure on businesses to adopt best practices in risk management. During the second half of 2008, Standard & Poor's began incorporating ERM into its discussions with non-financial companies that it rates and adding commentary about ERM in its reports. S&P is focusing initially on two facets of ERM—risk management culture and strategic risk management—and intends to eventually expand its assessment to encompass other ERM components.[17] Formal scoring of companies' ERM capabilities will likely commence sometime in 2009.[18] In addition to S&P, Moody's is also developing a process that considers ERM as a component of its ratings approach.[19]

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The implementation of an enterprise-wide approach to risk management is a challenging and lengthy process. For boards and executives just getting started, The Conference Board has published a helpful roadmap.[20] Regardless of a company's stage in implementing an enterprise-wide risk management framework, boards of directors of all companies should be re-evaluating the adequacy of their current risk management oversight procedures in light of the lessons learned from the financial crisis. Among other things, directors should address—

- *Director education*. All directors need to have a good understanding of their company's business and the major risks it faces. Without a good grasp of both the upside and downside risks, directors cannot properly oversee the company's strategic direction. Depending on the particular risks that a company faces, the company may need to beef up its board by adding members with expertise in particular areas of concern. Directors of companies that use complex hedging strategies to manage risks may need additional training or an external advisor to assist them. If a company has not yet adopted an enterprise-wide approach to risk management, the independent auditors or an outside consultant can provide the board with a basic overview.

- *Oversight structure*. The board should reassess the manner in which it oversees risk management. Depending on its size and how well it functions, a board may decide to retain overall authority for risk management oversight at the board level. At many companies, primary oversight responsibility for risk management is delegated to the audit committee. Often, though, audit committee members find themselves already burdened with a host of other responsibilities; therefore, the boards of some companies have set up separate risk management committees.[21] Even if primary oversight for monitoring risk management is delegated to a committee, the entire board needs to remain engaged in the risk management process and be informed of material risks that can affect the company's strategic plans.

- *Reporting processes*. Directors need to ensure that they are getting the information they need to understand the company's risks, as well as management's assessment of those risks. They also may want to meet privately with the company's principal risk officer and the internal and outside auditors to discuss risk management issues. If risk oversight is delegated among several committees, their activities and the sharing of information needs to be coordinated. Also, the board should reexamine how often risk management matters are discussed at board meetings.

- *Risk management review*. In light of the unprecedented turmoil in the credit and financial markets, the board (or the responsible committee) should review with management the adequacy of the company's current risk management practices. As the economy continues to weaken, particular attention should be paid to those systems and controls designed to manage an expanding universe of counterparty risk posed by lenders, insurers, suppliers, customers and other parties with which a company deals.

- *Executive compensation*. As we discuss more fully below, the board should reexamine its executive compensation policies in light of the company's risk appetite to ensure that executives are not being rewarded for excessive risk-taking.

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3. Investor Relations and Dealing with Activist Investors

In the 2008 National Association of Corporate Directors Public Company Governance Survey, for the first time, directors ranked shareholder relations as a "critical area"—that is, an area of relatively high importance but relatively weak board performance.[22] Maintaining and cultivating good investor relations will be even more important in 2009. Not only will there be the typical activists clamoring for change, but the average investor who has seen his stock portfolio and 401(k) account plummet in value will be critically evaluating company performance and management's message about how the company plans to weather the economic storm.

To mitigate investor backlash, companies need to be actively communicating their business strategies to the marketplace and cultivating relationships with core investors. They should also be taking advantage of the power of the Internet by making sure their Web sites are up to date and fully communicating the company's message. In addition, companies should be actively monitoring shareholder concerns and opinions that are expressed through blogs and other shareholder forums and proactively responding to any shareholder issues before they escalate.

The 2009 proxy season is expected to be another banner year for shareholder activism. A recent survey revealed that approximately 72 percent of activist investors responding expect the volume of shareholder activism to grow over the next 12 months, with the financial services industry expected to bear the brunt of the attention.[23] Other likely targets include companies underperforming relative to their peers.[24] As of December 4, 2008, RiskMetrics Group (formerly ISS) had already tracked 215 governance proposals that shareholders had submitted to companies, and this number will just continue to grow in the coming months.[25] Shareholder proposals for 2009 are expected again to target, among other things, executive compensation and corporate governance matters ranging from majority voting to bylaw amendments. A total of 80 shareholder proposals on majority voting were submitted in 2008, with only 24 actually making it to a shareholder vote, as most companies decided to voluntarily adopt the standard.[26] More than 73 percent of S&P companies now have majority voting.[27] At companies that have majority voting, shareholders have not been afraid to make their dissatisfaction known. The number of directors who failed to receive a majority of votes cast in favor doubled from 15 in 2007 to 30 in 2008.[28] Further, the number of directors receiving more than 15 percent of withhold/against votes increased from 543 in 2007 to 612 in 2008. As shareholders get more comfortable with the withhold/abstain concept in majority voting, we will likely see these numbers increase in the future.

Another proposal that companies can expect in 2009 relates to a recent Delaware Supreme Court decision regarding the legality of a shareholder-proposed bylaw amendment that would require a company to reimburse expenses incurred by an insurgent in a successful director election contest.[29] Although the court concluded that the bylaw amendment was a proper subject for shareholder action under Delaware law, the company was able to exclude the proposal because the court also held that the proposed bylaw mandated the board to reimburse expenses in all cases, which could prevent the company's directors from fulfilling their fiduciary duties.[30] Shareholder activists are likely to tweak the language of the proposed bylaw amendment to include "fiduciary out" language in response to the court's decision and try again in 2009.

While the 2009 proxy season is expected to see an increase in shareholder proposals, effective communications between companies and their shareholders could help minimize the number of these proposals that actually go to a vote. In 2008, 24 percent of proposals were withdrawn, with management and shareholders generally coming to an agreement after an open dialogue on the proposal.[31] Most shareholders would prefer to have meaningful discussions

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with management on company practices and proposed changes rather than fighting it out at an annual meeting. Such a willingness to communicate with shareholders shows that the board and management are responsive to shareholder concerns.

In deciding whether to accede to an activist's demands, directors should be wary of shareholder proposals that unduly interfere with the board's basic responsibility to manage the corporation for the creation of long-term value for all shareholders. Activists are often motivated by their own economic, social or political agendas and do not necessarily speak for the silent majority of investors. Also, as we discuss more fully below, boards should carefully weigh their responses to shareholder proposals to dismantle takeover defenses that can leave a company particularly vulnerable during this period of depressed stock valuations.

Even with good investor relations, some activists will not go away quietly. A record number of proxy fights (126) were announced in 2008, as activists ratcheted up their attacks on public companies.[32] Over half of these fights were either settled or withdrawn with the dissident's winning concessions in most of them.[33] Some have speculated whether hedge fund activists, many of which are struggling for their own survival and facing heavy redemptions, will be reined in to deal with bigger problems rather than fight with companies in which they invest. IGS Group, which advises hedge funds on raising money, expects that nearly one-third of hedge funds will shut down or merge due to struggling performance in 2008.[34] But activist hedge funds have among the longest lock-up periods in the hedge fund industry. Most likely, the deflated stock prices and depressed returns in today's market will make it hard for the survivors to stay away, as they will likely strive to enhance shareholder value in their investments in an attempt to get back to the shareholder returns of prior years.

4. Shoring Up Takeover Defenses

With share prices of most public companies depressed and hostile activity on the rise, it is critical that directors assess the adequacy of their company's takeover defenses. In 2008, there were at least 60 hostile or unsolicited takeover bids, representing approximately 22 percent of all announced bids.[35] In addition, 2008 was another record year for proxy fights.[36] We will likely see more of the same in 2009. Because the trend over the past few years has been for companies to dismantle their takeover defenses, often as a result of shareholder activism, many companies may be left vulnerable to takeover threats in this down market. Three takeover defenses particularly deserving director attention are the poison pill, advance notice bylaws and classified boards.

- ***Poison Pill*.** The use of poison pills as a takeover defense has been falling out of favor for several years, but many companies are now having a change of heart.[37] Through mid-November 2008, 53 public companies had adopted their first-ever poison pills, compared to 42 in all of 2007.[38] Many of these poison pills were the result of hostile activity, as evidenced by the fact that 24.5 percent of these 53 companies adopted the poison pill while the company was "in play"—in response to action being taken against it.[39]

Of the companies adopting poison pills, a significant majority are doing so without seeking shareholder approval, contrary to guidelines established by RiskMetrics. RiskMetrics will recommend that shareholders withhold their votes or vote against the entire board of directors if a company's board adopts or renews a poison pill without shareholder approval or does not commit to putting the pill to a shareholder vote within 12 months of adoption.[40] Although RiskMetrics continues to have a strong position against poison pills, shareholder activism targeting pills has come to a

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virtual halt, with only three poison pill shareholder proposals voted on in 2008[41], compared to as many as 99 proposals against poison pills in 2003.[42]

One alternative that is becoming increasingly popular among companies is to have a poison pill "on the shelf." In this situation, a board reviews and approves a form of poison pill that would be ready for adoption on short notice in response to a potential threat. The board then re-reviews the poison pill at reasonable intervals to ensure that its terms are appropriate in light of potential threats and current market practices. Taking this "on the shelf" approach has several advantages. First, it gives the board more time for a thoughtful and effective evaluation of the poison pill, in the absence of a pending threat. Also, having previously reviewed the poison pill, it enables the board to react quickly in response to an activist attack. Further, because there is no public disclosure requirement to merely having a poison pill "on the shelf", the board does not have the pressure to include the shareholder-friendly provisions recommended by RiskMetrics but, instead, can ensure that the poison pill has the teeth necessary to adequately protect the company.

As investors have significantly increased their use of derivative, swap and other transactions, often accumulating large positions in a company without having to disclose these positions publicly, some companies (44 to date) have adopted or amended poison pill language to cover these derivative positions when calculating an investor's ownership under the poison pill.[43] Companies should be cautious when considering this type of language in a poison pill because including derivative positions in the calculation of beneficial ownership under a poison pill is an emerging concept and has not been addressed by the Delaware courts. In addition, the lack of public disclosure on derivative positions could make it difficult for companies to monitor when a shareholder has triggered the pill, and the possibility of inadvertent triggers could increase.

- *Advance Notice Bylaws***.** Another takeover defense that companies should carefully review and, if necessary, update is their advance notice bylaws,[44] particularly in light of two recent Delaware court cases narrowly interpreting their effect.[45] In *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, the court held that the advance notice provision in CNET's bylaws applied only to proposals that a shareholder wishes to have included on management's form of proxy pursuant to Rule 14a-8 of the Securities Exchange Act of 1934 and, therefore, did not preclude an independently financed proxy solicitation. In *Levitt Corp. v. Office Depot, Inc.*, the court held that a shareholder did not have to give advance notice of its intent to run a short slate for the election of directors at Office Depot because the company itself had properly provided notice that the election of directors would be considered at the annual meeting, and there was no separate bylaw provision expressly addressing shareholder nominations.

These decisions highlight how important it is that advance notice bylaw provisions clearly and accurately reflect the company's intent. In particular, an advance notice bylaw provision should—

- clearly apply to all proposals made or sought to be made at any shareholder meeting, whether or not the shareholder wishes to have the proposal included in the company's proxy statement pursuant to Rule 14a-8
- set a deadline for notice of shareholder proposals that is in reference to the annual meeting date, rather than the mailing date of the proxy materials (which is a Rule 14a-8 concept) and is a reasonable period of time prior to the annual meeting

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- specify the information required in the notice rather than incorporate the requirements of the federal securities laws
- explicitly address shareholder nominations for directors, as well as other business proposed by shareholders

In addition to the above, companies should consider requiring shareholders who attempt to present proposals or nominate directors at a shareholder meeting to provide the company with additional information about any hedging or similar arrangements that have the effect of increasing or decreasing the shareholder's economic or voting power, any arrangements between the shareholder proponent and others concerning the shareholder proposal, and the shareholder proponent's relationship with the company and any significant shareholders. Companies should also consider requiring that this information be updated prior to the record date and within 10 days preceding the shareholder meeting. Requiring this information from shareholder proponents gives the company and its shareholders valuable insight into the shareholder proponent's motives and will help the company and its shareholders evaluate the proposal.

- ***Classified Boards*.** RiskMetrics and several other investment advisory firms view classified boards unfavorably and almost always recommend voting for a proposal to declassify a company's board. During 2008, activist shareholders placed 52 proposals to repeal classified boards on company ballots, an increase from 26 proposals in 2007.[46] These proposals were strongly supported by shareholders, with 67.1 percent of votes cast being in favor of board declassification.[47] Also, in response to pressure from activists, management submitted 43 declassification proposals to shareholders in 2008.[48]

Companies with classified boards should think carefully before succumbing to shareholder pressures to declassify the board, particularly in the current economic environment in which many companies are vulnerable to bottom-fishing offers. A classified board provides a company with additional leverage against a potential hostile acquiror because the acquiror is unable to gain control of a majority of the board at a single annual meeting. A classified board also strengthens the deterrent effect of a poison pill because an acquiror cannot replace a majority of the board at a single election and then redeem the pill.

In today's environment, it is critical for boards to be prepared to handle a potential takeover threat. Boards should be fully aware of their company's defense profile, as well as any vulnerabilities the company may have. Boards should also be monitoring the company's shareholder base and any unusual trading activity. They should also have in place a designated response team and plan of action if a threat arises.

5. Pay Practices Under Fire

Executive compensation, already one of the most controversial topics in America today, will likely be an even hotter topic in 2009. Press reports throughout 2008 of hefty bonuses and generous severance packages for executives of failing financial institutions have raised shareholder ire over excessive pay practices to new heights. We highlight below some of the challenges boards will face in crafting executive compensation in the midst of this growing public outcry.

- ***Shareholder Proposals*.** In each of the last two proxy seasons, more than 130 shareholder proposals on executive pay went to a vote.[49] Of these, the most popular proposals were (1) "say on pay" proposals, which call for an annual shareholder advisory vote on executive compensation and (2) pay for performance proposals, which seek a

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greater link between pay and performance. Many expected investors to rally behind these proposals in 2008, particularly with all the turmoil in the markets, but that was not the case. Average support for say on pay proposals remained fairly constant at 40 percent, and average support for pay for performance proposals actually decreased slightly from 27 percent in 2007 to 25 percent in 2008.[50] That being said, say on pay proponents did have some success. Eleven companies received majority support for say on pay, and 12 companies have agreed to conduct advisory votes voluntarily going forward.[51] Other companies took alternative measures, such as agreeing to meet annually with their largest investors to discuss executive pay, and Schering-Plough announced plans to survey shareholders to get their thoughts on director and executive pay.[52]

But 2009 rings in a new year, and all bets are off. More say on pay proposals are expected in 2009 than the 79 proposals submitted in 2008.[53] With Barack Obama's election to the presidency, companies should expect to see some sort of say on pay legislation in 2009, which could take effect as early as 2010. With say on pay likely to become a reality in the near future, boards should act now to ensure that their compensation practices are reasonable and closely tied to performance, which should help minimize opposition if and when shareholders get their "say on pay."

In addition to say on pay and pay for performance, the 2009 proxy season will likely be marked by proposals requesting that companies limit golden parachutes, establish anti-tax gross-up policies and claw back pay after a restatement of financials.[54]

- ***TARP.*** Boards of all companies should take notice of executive compensation-related provisions in recent legislation. In response to the financial crisis, Congress adopted legislation creating the Troubled Assets Relief Program (TARP), which applies to financial institutions that elect to receive financial assistance from the U.S. government. The legislation imposes certain restrictions on executive compensation at participating financial institutions, including—

  - stricter limits on deductibility of executive compensation under Section 162(m) of the Internal Revenue Code (Code), including lowering the $1 million cap on deductibility to $500,000 and eliminating the exception for qualified performance-based compensation
  - expansion of golden parachute penalties (20 percent excise tax and loss of corporate deductibility) under Section 280G of the Code to include not only circumstances involving a change in control, but also involuntary terminations and terminations in connection with a bankruptcy, liquidation or receivership
  - prohibition on pay practices that encourage executive officers to take "unnecessary and excessive risks that could threaten the value of the financial institution"
  - requirements that companies claw back bonuses and incentive pay of certain executive officers if the payment was based on materially inaccurate financial statements
  - prohibition from making any golden parachute payments to certain executive officers.[55]

Although these restrictions apply only to participating financial institutions, boards of all types of companies should consider these restrictions when reviewing executive compensation practices. In a recent speech, John White, director of the SEC's Division of Corporation Finance, suggested that it would be prudent for all compensation committees to consider the particular risks that executives might be motivated to take under compensation arrangements.[56] As we

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discussed above, as part of a comprehensive, enterprise-wide approach to risk management, companies should be identifying those risks that can materially threaten the value and survival of the enterprise. Once those risks are identified, the compensation committee should assess each element of executive compensation to determine whether it could encourage executives to take those risks, and then decide whether the compensation package should be adjusted to minimize excessive risk-taking.[57]

In today's volatile environment, and with a new president-elect entering the mix, many expect that shareholder activists will push for proposals similar to those imposed under TARP, either through new legislation or shareholder activism, which could have an effect on all companies, not just financial institutions. Some shareholder activists are already using TARP's executive compensation requirements to push for even stronger reforms among financial institutions that have availed themselves of the government relief. Several unions have recently submitted resolutions to companies such as JPMorgan Chase, Bank of America, American Express and SunTrust Bank recommending that directors adopt reforms above and beyond the TARP restrictions that would, among other things, limit annual incentive compensation, require senior executives to hold at least 75 percent of stock obtained through equity awards for the duration of their employment and limit severance pay to one or two times the executive's salary.[58]

- *Compensation Discussion and Analysis (CD&A)***.** After having two years to deal with executive compensation disclosure rules, the SEC is expecting companies to step up this year with improved CD&A disclosure. The SEC is particularly focused on—

  - clearer discussion of how companies arrived at the compensation for each named executive officer
  - disclosure of performance targets and limiting reliance on the competitive harm exception
  - benchmarking and how companies use this tool to make executive compensation decisions.[59]

In addition to the above, companies should carefully consider how the recent financial crisis and related events have affected their executive compensation programs. Discussion and analysis will need to be included if the company took any action due to a depressed stock price or the slowing economy, such as modifying or waiving performance targets, modifying awards or plans, or repricing or replacing existing options or other equity awards.

In light of the public outcry and shareholder activism over excessive compensation practices, boards should be mindful that actions relating to executive compensation will face increasing public scrutiny in 2009. Boards should not only ensure that executives are compensated appropriately when the company performs well, but should also carefully consider appropriate adjustments to compensation when the company does not perform. Each element of executive compensation needs to be well thought out and justifiable. Particular practices that can stir investor ire include excessive perquisites, excise tax gross-ups, absence of clawback policies after a restatement of financials, excessive golden parachutes, salary and bonus guarantees, single-trigger change in control provisions and death benefits (golden coffin arrangements).

RiskMetrics has adopted a policy that recommends withholding votes from compensation committee members if a company has what RiskMetrics considers to be "poor" compensation practices. Compensation committees and boards that do not adhere to good compensation practices will increasingly find themselves subject to shareholder "withhold

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the vote" campaigns. In November 2008, RiskMetrics updated its policy to add the following to the list of items considered to be poor pay practices—

- tax reimbursement arrangements for any executive perquisites or other payments
- payments of dividends or dividend equivalents on unearned performance awards
- modified "single-trigger" change-in-control provisions, which allow change-in-control payments upon voluntary resignations following a change in control
- broad change-in-control definitions in individual contracts or equity plans that could result in payments to executives without an actual change in control.[60]

- *Underwater Stock Options***.** Another challenge that many boards will face in 2009 is how to deal with stock options that are underwater due to plummeting stock prices over the past year. These underwater stock options could be a significant issue for companies, particularly where stock options are used to motivate and incentivize an executive and constitute a major part of the executive's compensation. Although there are various ways to deal with underwater stock options, careful consideration needs to be given to each. Companies may choose to exchange the options, either for a fewer number of shares of restricted stock, or for options having a lower exercise price, or for cash. Alternatively, depending on a company's situation, it may have enough shares available in its compensation plans to simply issue additional options with lower exercise prices, or it may have enough cash on hand to implement other cash bonus programs to incentivize executives.

Although these options seem fairly straightforward, companies must evaluate the consequences of these actions. First of all, NYSE and Nasdaq listing standards generally require shareholder approval for repricing options to a lower exercise price, or cancelling options in exchange for other stock awards. Obtaining shareholder approval for additional compensation for executives might be hard to come by in today's environment, particularly with proxy advisory services and institutional shareholders opposing these actions unless they meet specific criteria. RiskMetrics will not consider market deterioration, in and of itself, an acceptable reason for a company to reprice underwater stock options or reset performance goals, and unless the plan meets certain criteria, RiskMetrics will recommend that shareholders vote "no" for the repricing or exchange.[61] Other considerations that boards should evaluate include tax and accounting implications, securities issues relating to tender offers, public disclosure requirements and investor relations. There is no clear answer on what companies should do with underwater stock options, so boards must evaluate their company's individual situation to determine the best solution.

6. Succession Planning

Directors ranked CEO succession as one of the top three concerns for boards, according to the 2008 National Association of Corporate Directors Public Company Governance Survey.[62] Although directors recognize the importance of CEO succession, only 58 percent of boards surveyed indicated that they had a formal succession plan in place[63], and only 16 percent of directors believe that their board is effective at CEO succession planning.[64] The need for effective succession planning is particularly acute in the current economic environment, with CEO turnover at or near record highs.[65]

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With the importance placed on CEO succession, why do boards fail at having effective plans in place? Perhaps it is because the current CEO is performing well, so they think succession planning can wait, or because it involves uncomfortable conversations with the current CEO, or because much of a board's time is spent addressing the day-to-day obligations, so succession planning gets pushed to the back burner. Whatever the reason, boards need to turn their time and attention to addressing CEO succession and be sure they have a credible, specific and actionable CEO succession plan in place at all times. The departure of a CEO, whether it is a surprise departure or a planned retirement, has a significant impact on an organization's operations, culture and morale, and the failure to have an effective plan to handle the situation can damage the company's credibility and erode shareholder value.

So what should boards be doing? Directors should periodically have in-depth discussions on CEO succession, preferably at least once a year. Boards need to have a clear understanding of the leadership talent and skills necessary for the position, and potential candidates, both internal and external, should be identified. Boards should not wait for a CEO vacancy to get to know the candidates and their strengths and weaknesses. If the candidates are internal, the board should take a proactive role in grooming candidates for the position by ensuring they have the right leadership skills and are receiving necessary training for the CEO role. To minimize the disruption of a CEO's departure, boards should also have a process in place that details the board's plan for CEO succession, as well as the procedures and governance response necessary once a CEO has announced his or her departure. Selecting the right CEO is one of the most important actions that boards will take, so it is critical that boards make an investment in CEO succession planning.

7. Planning for the Obama Administration

Barack Obama's election to the presidency, coupled with fortified Democratic majorities in both houses of Congress, will introduce significant, if not seismic, changes to the ways U.S. companies conduct business, both domestically and abroad. Management and directors need to monitor these changes because they will likely require adjustments to business plans, budgets and even the strategic direction of many companies. Akin Gump has published in-depth reports on the likely impact of the Obama administration on American business that are available here. We summarize below some of the key areas of change.

Economic Stimulus Plan. Barack Obama's first priority following his election will be passage of some sort of massive government spending plan to jolt the economy back to life. Many of Obama's campaign proposals will be rolled into the two-year stimulus package, which is expected to cost well in excess of $700 billion and is intended to create or save 2.5 million jobs. While details have not been worked out, the plan will involve, among other things, rebuilding the country's aging infrastructure, providing business incentives for alternative energy and "green" technologies, and grants and tax incentives for health information technology.

Labor and Employment. The new administration and Congress will be particularly active in legislation and regulation affecting the workplace. One of their earliest priorities is expected to be legislation that will fundamentally change the rules in labor-management relations in the United States by (1) allowing unions to bypass supervised secret-ballot elections and, instead, become certified bargaining representatives by collecting a majority of authorization cards from employees and (2) requiring a special arbitration panel to dictate the terms of the first collective bargaining agreement if the company and union cannot reach an agreement within a specified period of time. The "card-check" authorization will allow unions to gather signatures discreetly without any opportunity for the

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employer to advocate its position, and the mandatory arbitration provision will allow a third party to decide the proper wages, benefits and other terms of employment for employees in contrast to current law that requires employers to bargain, but does not require them to agree to any terms, with unions.

Other likely labor measures include legislation to narrow the definition of "supervisor" under the National Labor Relations Act (thereby expanding the number of employees eligible for unionization), greater protection against discriminatory employment practices and expansion of occupational safety regulations.

International Trade. There is little doubt that President-elect Obama will break with his predecessor and seek to set a different course for U.S. trade policy. A centerpiece of his campaign was a tougher trade policy that emphasized security for U.S. workers, as well as improved labor and environmental standards in trade agreements. Consequently, there will likely be changes to NAFTA, as well as to bilateral trade agreements. He will also likely place greater emphasis on enforcement of existing U.S. trade agreements and may add new monitoring and enforcement measures, particularly with respect to China. These measures might include more vigorous defense of intellectual property rights, new food and consumer safety import regulations and penalties for currency manipulation. The Obama administration is also likely to implement tighter cargo security measures.

Climate Change/Energy/Environment. President-elect Obama has indicated on more than one occasion since his election that he intends to push forward with climate protection legislation, even though the public's appetite for costly control measures has waned as oil prices have plummeted and the recession has deepened. Obama supports a cap-and-trade system designed to reduce carbon emissions levels 80 percent by 2050. Under Obama's plan, all pollution credits would be auctioned. To spur Congress to act, the Obama camp has indicated that it may rely on a 2007 U.S. Supreme Court ruling that greenhouse gases (GHG) are pollutants under the Clean Air Act. That decision means that the EPA can decide whether or not the emissions pose a danger to the public and should be regulated. Consequently, the EPA may propose rules setting the stage for regulation pursuant to existing laws, at least in part as a means to impel Congress toward adoption of comprehensive legislation. Even if a major climate protection bill is not passed in 2009, many analysts expect U.S. lawmakers at least to reach a consensus on what needs to be done so that the United States can arrive at a December 2009 United Nations summit on climate regulation with an achievable plan.

During his campaign, Obama proposed a $150 billion investment in clean energy over 10 years, although Obama has also pledged to use part of his 2009 economic stimulus package for the creation of "green jobs" and the development of alternative energies. Obama also supports completion of the Alaska Natural Gas Pipeline as a means of delivering a new clean fuel source and as a means of creating jobs. While Obama has vowed to keep coal as part of the fuel mix, it remains to be seen whether coal-fired power plants can survive under mandatory cuts in greenhouse gas emissions. Obama also supports domestic exploration and production of oil and gas in the near term, including a "use-it-or-lose-it" requirement that would force companies to develop 68 million acres for which they currently have leases but have yet to drill. He has also called for efforts to speed up the recovery of oil and gas resources from shale formations and has additional plans for the support of renewable energy sources and other clean technologies.

Tax. Two key planks of Barack Obama's campaign were (1) his pledge to end tax breaks to companies overseas and (2) a $3,000 tax credit for American businesses for each new job created in the United States. Another centerpiece of his campaign was legislation that would give a one percent tax credit to qualifying "Patriot" employers

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who, among other things, provide certain benefits to their employees and preserve or increase U.S. jobs relative to jobs in other countries.

8. Climate Change On Front Burner

In the coming year, companies will face increased pressures from investors and regulators to provide more disclosure about climate change risks and liabilities and to step up their efforts to curb carbon emissions.

A record 66 shareholder proposals urging companies to tackle global warming and sustainability issues were submitted to public companies in 2008, compared to 40 in 2007.[66] More than a third of these proposals were withdrawn after proponents successfully reached agreements with companies on additional disclosure or other actions. Of those proposals that were voted on, proposals requesting reports on greenhouse gas emissions averaged 32 percent support, proposals calling for adoption of quantitative GHG reduction goals averaged 20 percent support and proposals seeking comprehensive sustainability reports averaged 22 percent.[67] These results are noteworthy because social and environmental proposals historically have received less than 15 percent support.[68]

Government agencies are also turning up the heat on companies to provide more robust disclosure. In 2007, New York Attorney General Andrew Cuomo subpoenaed five major energy companies demanding information about the adequacy of their disclosures of climate risks. This fall, two of the companies reached settlements in which they agreed to provide additional disclosure in their annual reports on Form 10-K. Also in 2007, and again in 2008, broad coalitions of institutional investors and public interest groups petitioned the SEC to provide additional interpretive guidance clarifying the obligations of public companies to assess and disclose the legal and financial consequences of climate risks.

In light of these pressures, it is not surprising that companies are beefing up their disclosures. A recent study noted that in the first quarter of 2008, companies mentioned “climate change” 7,634 times in their SEC filings, compared to just 536 times in the first quarter of 2006.[69] In addition to devoting more attention to climate change risks in their SEC filings, companies are also voluntarily disclosing more information about climate change and sustainability efforts. Almost two-thirds of S&P 500 companies now respond to an annual questionnaire on climate change issues and GHG emissions distributed by the Carbon Disclosure Project, a coalition of more than 385 institutional investors with $57 trillion in assets under management.[70] Although participation is voluntary, companies that choose not to respond to the questionnaire are often the target of climate-related shareholder proposals. In addition, following Wal-Mart’s lead, several major companies have partnered with the Carbon Disclosure Project in requesting climate change disclosures from suppliers. More than half of the United States’ 100 largest public companies also voluntarily report on their sustainability efforts, with 49 percent publishing separate sustainability reports.[71] These reports address a variety of social, environmental and governance issues on how a company is meeting current needs without compromising the ability of future generations to meet their needs.

The EPA is also expected to mandate additional carbon emission disclosure. In 2008, Congress passed legislation directing the EPA to develop “mandatory reporting of greenhouse gas emissions above appropriate thresholds in all sectors of the economy.” While the legislation requires the EPA to publish a proposed rule by September 2008 and a final rule by June 2009, the EPA has yet to comply.

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Apart from disclosure issues, many companies will face increasing state and federal regulation of greenhouse gas emissions. We discussed above the prospects for increased federal regulation under the Obama administration. At the state level, over 36 states have adopted direct action plans regarding climate change. A coalition of 10 northeastern states under the Regional Greenhouse Gas Initiative held the first auctions of government-issued carbon dioxide allowances in September and December 2008. In December 2008, California regulators adopted a sweeping plan to slash GHG emissions and establish a carbon trading program. While most of the plan takes effect in 2012, some portions of the plan, including mandatory emissions reporting, will go into effect in 2009. Several other states are expected to unveil their plans in 2009. A coalition of seven western states (including California) and four Canadian provinces are moving towards a joint cap-and-trade program, a group of six Midwestern states and one Canadian province are signatories to a GHG reduction accord, and a group of 10 northeastern states is currently implementing a cap-and-trade program for power plants.

9. Looming Litigation Wave

Companies and their directors can expect to be targeted with more lawsuits and government probes during 2009. What began in late 2007 as a wave of subprime-related litigation has swelled into a storm surge of suits being filed against financial institutions caught up in the credit crisis, as well as companies hard hit by the economic downturn.

Securities class action lawsuits filed in 2008 are currently on pace to hit a six-year high of 267, a 37 percent jump over last year's total and more than double the number filed in 2006.[72] Next year may be just as active, as class action suits are strongly correlated with high volatility in the stock market and large price drops in a company's stock.[73] While subprime-related and auction-rate securities cases comprise almost half of the new litigation, there has also been a significant increase in more traditional class action cases.[74]

In addition to rising shareholder litigation, the SEC has been stepping up its enforcement activities. In 2008, the SEC brought 671 enforcement actions, its second highest total ever.[75] While a great number of these enforcement cases focused on players in the subprime and financial markets, SEC staff have indicated that they expect to see an increase in the coming year in actions involving companies in other sectors.[76] Accounting fraud cases, in particular, are likely to increase. With more companies cutting back, there will likely be an uptick in laid-off employees blowing the whistle on alleged wrongdoing. Also, with the economic downturn, some companies will be tempted to massage their numbers to meet covenant requirements in debt instruments. Another area of SEC and Justice Department focus is the Foreign Corrupt Practices Act. In the past two years the SEC has brought more FCPA actions than it did in the prior 28 years combined[77] and capped off 2008 with a record $800 million settlement of FCPA charges against Siemens AG. SEC staff expect even higher attention will be paid to FCPA cases in 2009.[78] Also, with the SEC facing mounting criticism for alleged failures to adequately police financial institutions and, most recently, to uncover the Bernard Madoff fraud, we can expect a major internal review of the agency during 2009, which will likely lead to enhanced enforcement efforts involving public companies. The Obama administration is also expected to be much tougher in cracking down on environmental and workplace violations.

Companies will also likely see an increase in commercial litigation involving lenders, suppliers and customers, as the slumping economy forces many parties to renege on contracts.

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10. Director Protection

Directors face enough challenges today without also having to worry about whether they might face personal exposure in the event they are targeted by a shareholder suit or government investigation. Directors should make sure that the company's indemnification arrangements and director and officer insurance policies will protect them to the maximum extent allowed against personal liability for their actions as directors.

- *Indemnification/fee advancement arrangements***.** Most public corporations provide in their bylaws (and sometimes in their charters) broad indemnification rights to current and former officers and directors. They also typically require the company to advance legal fees to such persons in connection with indemnifiable claims. Directors should ensure that these provisions are state-of-the-art, particularly in light of a raft of recent Delaware cases interpreting these types of provisions.[79] Among other things, a Delaware court recently held that a company could unilaterally amend its bylaws to eliminate its obligation to advance expenses to a former director.[80] The decision surprised many practitioners who had assumed that such rights vest when a director's service on the board begins. Directors should make sure that the company's bylaw or charter provisions specify the contractual nature of the rights to indemnification and advancement of expenses, that the rights vest at the time the director first joins the board and regardless of when a claim is asserted and that the provisions cannot be amended retroactively to diminish these rights. To avoid doubt, companies and directors may also wish to enter into separate indemnification agreements that clearly cannot be amended without the consent of both parties. Approximately one quarter of Fortune 500 companies have separate indemnification agreements with directors.[81]

- *D&O Insurance*. In light of the financial crisis, directors should reassess the amount of coverage provided by their company's D&O insurance policy and make sure they understand the exclusions from coverage. In this age of increased counterparty risk, directors should also monitor the financial strength of the D&O insurance carriers. Also, with the risk of bankruptcy heightened for almost any company, directors should make sure that they understand their rights and the priority of payments under the company's policy in the event the company must seek bankruptcy protection. Some companies are also purchasing for their directors separate excess side A policies that cannot be exhausted by payments to the corporation and are beyond the reach of the company's creditors, while other companies are purchasing additional coverage for independent directors.

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