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Corporate Governance In A Bad Economy

The Editor interviews ***Terry M. Schpok,*** *P.C., Partner, Dallas Office, Akin Gump Strauss Hauer & Feld LLP.*

Editor: What are some of the important strategic topics for boards to consider in 2009?

Schpok: A number of topics should be considered by boards in the current environment. I would include formulating corporate survival plans, reviewing takeover defenses, monitoring liquidity and financial condition, evaluating potential opportunities and reassessing the strategic direction of the company.

Editor: How can boards contribute to developing a strategy designed to assure survival?

Schpok: Directors need to be satisfied that management will take appropriate and timely steps to address the effect of swings in the economy during this period of crisis.

I moderate a monthly roundtable discussion with CEOs here in Dallas to talk about concerns of common interest. They place considerable importance on the need for management to develop contingency plans that can be presented to the board in advance and which are based on various assumptions relating to the economy and the company's operations and finances. These plans can be vetted by the board in advance to be promptly implemented in case the economy or the company's circumstances deteriorate in a way that would trigger the contingency plan. This approach permits a company to react quickly should an emergency occur so that the board is not surprised by a situation that could have been anticipated.

Terry M. Schpok

Editor: How should a company shore up its takeover defenses?

Schpok: Many companies have depressed stock prices, which makes them potential targets for acquisition at a time of significantly reduced shareholder value. Therefore, they need to address the adequacy of the company's takeover defenses. Three important lines of defense include:

First. Evaluation of a shareholder rights plan. The plan is designed to assure that someone who is attempting a hostile takeover must deal with the board of directors. Although shareholder rights plans have been the subject of criticism from shareholder activists for several

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years, boards are now reassessing the importance of having a rights plan available in the current environment.

Boards are becoming increasingly interested in having a rights plan "available on the shelf." The board reviews and approves the form of a plan that is ready for adoption on short notice in response to a potential threat to the company. The board can re-review the plan at reasonable intervals to ensure that its terms are and remain appropriate in light of potential threats and current market conditions.

This approach has several advantages. It gives the board more time for a thoughtful and deliberate evaluation of the plan in the absence of a pending threat. It enables the board to react quickly in response to an activist attack. The company doesn't have to disclose a plan that has not been adopted. This allows the board to immediately adopt a plan previously evaluated by the board that contains the provisions necessary to adequately protect the company.

Historically, rights plans have not included derivative holders as underlying beneficial owners in a manner that would trigger the operation of the rights plan. Accordingly, some boards have amended rights plans to include derivative securities in the calculation of an investor's ownership. However, if provisions are included in the rights plan that trigger the plan upon the acquisition of derivatives, the risk of an inadvertent triggering of the plan is increased because the lack of public disclosure of derivative positions could impair the company's ability to know when a shareholder has triggered the plan.

Second. The board should adopt advance notice bylaw provisions that clearly apply to all proposals sought to be made by a shareholder at any shareholder meeting whether or not the shareholder wishes to have the proposal included in the company's proxy statement under Rule 14a-8. The bylaws should also 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. The bylaw provision should specify the information required in the notice rather than just incorporate the requirements under the federal securities laws and should explicitly address shareholder nominations for directors as well as any other business proposed by the shareholders.

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

Third. Boards should consider whether maintaining or implementing a classified board should be part of the company's anti-takeover strategy. Companies are taking a new look at classified boards as a means to impair the ability of a hostile bidder to take immediate control of the board and use that control of the board to rescind the shareholder rights plan in order to clear the way for a hostile takeover.

Shareholder rights plans are not effective against those seeking to obtain control solely through nominees to the board. That's why a board should have mechanisms in place, including advance notice provisions of the kind I mentioned and a classified board to reduce the risk that someone can circumvent a shareholder rights plan and gain control through a proxy fight.

Finally, a number of companies have change-of-control provisions in debt instruments and employment agreements or certain types of incentive plans where a change of control at either the board level or the shareholder level triggers a default under debt agreements and a significant payment under employment agreements or incentive plans. These provisions can be an effective anti-takeover deterrent in appropriate circumstances.

Editor: Why should a board carefully monitor the company's liquidity and financial conditions?

Schpok: The board should be aware of the company's financial situation as well as that of counterparties (including customers and suppliers) upon whom the company relies. This year, a large amount of corporate debt is coming due that will need to be refinanced in some way. There are significant challenges to refinancing that debt at a reasonable cost in the current market.

The board should understand what steps management is taking to address the company's debt requirements, including whether the company is going to be in default under debt covenants or whether scenarios could develop that would in fact trigger a default. The board should be familiar with the company's plan for either renegotiating or refinancing debt or raising other sources of capital to best preserve a company's liquidity and capital position. Because of the frozen credit market, many companies are having to look at ways to raise capital in the equity markets at depressed prices. Similarly, the financial condition of large customers, suppliers or other parties having business relationships with the company can impact the company's own financial condition.

Editor: Does the current situation open opportunities as well?

Schpok: A sale of a company may be the best solution to its current financial situation. Given current market conditions, there are opportunities to make acquisitions on very favorable terms that make sense for both the acquiring company and the acquired company. However, I frequently see three potential obstacles encountered by buyers.

The first is that many private equity buyers have cash but are having trouble raising debt to leverage acquisitions on acceptable terms. Without debt, they don't have the leverage required to generate the returns they require.

The second is that companies with good credit ratings frequently need to refinance their existing credit facility in order to make a significant acquisition, but are finding that the credit terms which might be currently available to them are not as favorable as the terms they already have in place under existing debt facilities.

The third obstacle occurs when an acquirer identifies acquisition candidates based on their current value, but as soon as the acquirer approaches a candidate, the fiduciary duties of the board of the candidate require it to go through a shopping or auction-type process that will drive up the price of the candidate to a point that is no longer attractive to the buyer.

Editor: Should companies reevaluate their strategic direction in the light of the current crisis?

Schpok: Yes. This goes back to the board's fiduciary duties. A board can be criticized for not making an informed decision if in fact the board hasn't analyzed the effect on the company of the current crisis and the prospects for the company in this environment.

The financial meltdown and the whole global economic crisis have exposed companies to a range of risks that they never anticipated. Therefore, boards need to take a close look at whether current risks affect the viability of the company's business model and whether the company's strategic direction continues to be feasible in the new environment.

As part of this process, the board should be aware of current and proposed government regulations, changes in the industry, the status of the company's business relationships and other factors that would affect the company's ongoing strategic plan.

Editor: Let me ask you about the role of the board with respect to risk management.

Schpok: A number of surveys have recently ranked risk management as one of the top concerns of a board. The cliché "desperate times breed desperate measures" has particular relevance today. Many boards are focusing on ensuring that management does not take desperate measures that may ultimately be challenged as improper, illegal, or exceptionally risky. The board should assure itself that the company is dedicated to enterprise risk management, meaning a top-down, holistic approach to risk management, including an assessment of operational, financial, strategic, compliance, and reputational risk. This approach eschews looking at each category independently in favor of assessing the company's overall risk.

Because the current financial crisis is generally attributed to poor risk management, boards should consider whether they have the ability to effectively monitor risk management. They should assure that the company has an education program that provides directors with a good understanding of the company's business and the major risks it faces. Depending on the nature of the risk and, particularly, new risks, a company may need to consider changing or adding board members with expertise in particular areas of concern. There also should be an oversight structure within the board to assure that regular periodic reports from those involved in the risk management function are provided to the board.

The entire board should remain engaged in the risk management process and be kept informed by any board committee that is reviewing details of the process on an ongoing basis. Finally, directors also need to be sure that they are getting information that they need to understand the company's risks as well as management's assessment of those risks. They need to be sure that management is properly assessing risks. They should review current risk management practices with the company. The board should also know what the company is doing to respond to and assess counterparty risk that may be posed to the company by lenders, insurers, suppliers, customers or other parties to business relationships the company.

Editor: Is executive compensation a risk management topic as well?

Schpok: As a matter of overall risk management, the board should examine its executive compensation policies to ensure that executives are not being rewarded for excessive risk-taking. Beyond that, the board should review executive compensation to ensure that compensation in general is in line with appropriate standards, bearing in mind that it is a major target of criticism by activist shareholders. The board should review and be prepared to justify any pay practices that are commonly criticized, such as excessive perks, excise tax gross-ups, excessive golden parachute payments, salary and bonus guarantees and repricing of options.

Editor: How can board members mitigate their potential exposure?

Schpok: Boards should be prepared to have their decisions closely scrutinized in the current economic environment, particularly when corporate survival is at stake. The number one way to mitigate the exposure of board members for decisions that a board must make in this environment is proper preparation and planning to assure that the board has followed appropriate procedures for its analysis of risk management issues as well as its analysis of any valuation issues relating to change-of-control transactions.

The business judgment rule protects the board's decisions as long as the board has established an appropriate basis for the decision and has gone through the process of arriving at its decision by considering all relevant information and conducting a process that cannot be easily challenged on the basis of failure to exercise the board's duty of care.

The second area that a board should review is indemnification agreements. Although most charters and bylaws typically contain indemnification provisions, courts have held that such provisions could be amended by a board or by shareholders. In order to avoid the exposure of a potential unilateral amendment to indemnification rights, directors should consider having a contractual indemnity arrangement with the company where there is an indemnity agreement between the director and company that cannot be unilaterally amended or changed by the company.

A third area to mitigate director risks is to assure that the company has adequate director and officer insurance coverage in effect. The board should have the policy reviewed by someone who has the expertise in director and officer insurance coverage to evaluate the amount and scope of the coverage as well as exclusions from coverage. The board should also consider the stability and reputation of the insurance carrier writing the insurance to ensure that insurance is provided by a carrier that has the financial strength to perform on the policy.

The combination of following proper procedures and having appropriate indemnification and insurance coverage will typically mitigate the risks to board members of any challenge to the board's actions.