

TOP 10 TOPICS

For Directors in 2016



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contents

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Top 10 Topics for Directors in 2016

U.S. public companies face a host of challenges as they enter 2016. Here is our annual list of hot topics for the boardroom in the coming year:

1. Oversee the development of long-term corporate strategy in an increasingly interdependent and volatile world economy
2. Cultivate shareholder relations and assess company vulnerabilities as activist investors target more companies with increasing success
3. Oversee cybersecurity as the landscape becomes more developed and cyber risk tops director concerns
4. Oversee risk management, including the identification and assessment of new and emerging risks
5. Assess the impact of social media on the company's business plans
6. Stay abreast of Delaware law developments and other trends in M&A
7. Review and refresh board composition and ensure appropriate succession
8. Monitor developments that could impact the audit committee's already heavy workload
9. Set appropriate executive compensation as CEO pay ratios and income inequality continue to make headlines
10. Prepare for and monitor developments in proxy access.

1. Strategic Planning Considerations

Strategic planning continues to be a high priority for directors and one to which they want to devote more time.¹ Figuring out where the company wants to — and where it should want to — go, and how to get there, is not getting any easier, particularly as companies find themselves buffeted by macroeconomic and geopolitical events over which they have no control. In addition to economic and geopolitical uncertainty, we highlight below a few other challenges and considerations for boards to keep in mind as they strategize for 2016 and beyond:

- **Economic/geopolitical outlook.** On the economic front, the U.S. economy is going strong, at least compared to the rest of the world. The global economic outlook remains tenuous. Growth in China, the world's second largest economy, dipped to a six-year low in the third quarter of 2015, and economists predict its slowdown may continue for some time.² Japan, the world's third largest economy, has fallen back into a recession despite "Abenomics," the economic stimulus program crafted in 2012 to revitalize Japan.³ Rising geopolitical tensions, including apprehension about the spread of ISIS terrorism, instability in the Middle East, and the ongoing Syrian conflict and refugee crisis, are also casting a shadow over the world economic picture. Directors need to consider, among other things, how this global uncertainty and volatility could likely impact their company's business and ensure that the company's strategic direction takes these factors into account.
- **Achieving growth.** One of the biggest challenges facing companies is finding ways to drive top-line growth, preferably through organic growth, which is often the toughest to achieve. After the financial crisis, profit growth was driven largely by cost-cutting. With costs now cut to the bone, many companies have turned to M&A to drive growth, leading to another record-setting year for M&A. With so few options available for top-line growth these days, directors face important strategic decisions about how best to deploy their assets to grow profits, particularly with U.S. economic growth predicted to be around 2.5 percent in 2016.
- **Short-term vs. long-term.** Short-term successes breed immediate economic gain. We live in a world where patience seemingly is no longer a virtue. Accordingly, it has become more and more difficult for directors to focus on long-term goals and enhance long-term shareholder value in the face of "What have you done for me today?" Despite mounting pressures to deliver short-term results, directors must remain focused on

governing for the long term and achieving long-term shareholder value. According to PricewaterhouseCooper's (PwC) 2015 Annual Corporate Directors Survey, an increasing number are doing just that. Fifty-eight percent of directors surveyed say their company's strategic time horizon is five years or longer, compared to just 48 percent in 2011.⁴ And only 39 percent of directors now say that they use a one-to three-year horizon, compared to 52 percent in 2011.⁵

- **Effect of low oil and gas prices.** Another year of record low oil and gas prices has continued to both boost and wreak havoc on companies, depending on the industry. The low prices have benefited many sectors of the U.S. economy, including consumers who are enjoying the extra money in their pocketbooks. At the same time, however, these low prices have truly challenged energy companies, as they have watched their stock prices drop and have had to cut costs, reduce workforces, delay investments and significantly reduce capital spending. The cheaper valuations have created synergistic opportunities for some, while others continue to seek partners or other lifelines to get them through this rough patch. Directors in all industries need to understand the challenges and opportunities that low oil prices may create for their companies and ensure that the companies' strategies address them.
- **Cash stockpiles.** U.S. companies continue to stash cash, having grown their cash stockpiles to \$1.4 trillion as of mid-2015.⁶ Ultimately, companies will need to make important strategic decisions on whether, and when, to deploy these funds, particularly as shareholders demand more return on their investments. Many companies have already increased their stock buybacks and dividends, which are on track to hit a new high of \$1 trillion this year.⁷ While stock buybacks and dividends create shareholder value, directors need to consider whether choosing to buy back stock and issue dividends in lieu of other investment and growth opportunities is the best use of corporate funds.
- **Climate change.** Climate change can be a highly polarizing topic, but it is hard to ignore the headlines blaming climate change on melting ice sheets, extreme heat waves, droughts, flooding, wildfires and more. Companies should assess — or reassess — and quantify the opportunities and risks that climate change and resource scarcity may present to the company and determine what role it may play in the company's strategy. Companies also need to pay attention to their disclosures on climate change risk and liabilities as government agencies have recently turned up the heat in this area, and many expect it to continue. In November 2015, New York Attorney General Eric Schneiderman subpoenaed Exxon Mobil, seeking documents to determine whether the company lied to investors and consumers or withheld information about the effects of climate change. Also in November, Peabody Energy reached a settlement with Schneiderman after a two-year investigation found that Peabody's disclosures about the potential impact of climate change did not always square with its internal financial projections.
- **Corporate social responsibility.** Climate change is only one aspect of the broader corporate social responsibility initiative. More and more companies are integrating corporate social responsibility into their businesses, and more and more shareholders are asking companies to conduct their business in a socially and environmentally responsible manner. Boards should try to understand their stakeholders' views on this topic and any related investment policies they may have. Several U.S. companies now publish corporate social responsibility annual reports to, among other things, help shareholders understand what the company is doing to be a good corporate citizen environmentally, socially and ethically. Although social responsibility is of growing importance to many shareholders, in addition to the benefits of being socially responsible, boards must also weigh the consequences that could arise if corporate assets are deployed for social causes rather than profit, as well as the potential liability if the company does not live up to the social responsibilities that it discloses to shareholders.

2. Shareholder Activism

Shareholder activism and “suggestivism” continue to gain traction. With the success that activists have experienced throughout 2015, coupled with significant new money being allocated to activist funds, there is no question that activism will remain strong in 2016.

In the first half of 2015, more than 200 U.S. companies were publicly subjected to activist demands, and approximately two-thirds of these demands were successful, at least in part.⁸ A much greater number of companies are actually targeted by activism, as activists report that less than a third of their campaigns actually become public knowledge.⁹ Demands have continued, and will continue, to vary: from requests for board representation, the removal of officers and directors, launching a hostile bid, advocating specific business strategies and/or opining on the merit of M&A transactions. But one thing is clear: the demands are being heard.

Many activist investors have evolved from corporate gadflies to powerful and increasingly dominant forces as they have gained support and credibility from institutional investors. According to a recent survey of more than 350 mutual fund managers, half had been contacted by an activist in the past year, and 45 percent of those contacted decided to support the activist.¹⁰ Mutual funds supported many prominent activist campaigns in recent years, including ValueAct Capital Management LP’s board seat at Microsoft, Starboard Value LP’s removal of the entire board at Darden Restaurants and an investor’s push for a quicker stock buyback at General Motors.¹¹

With the threat of activism in the air, boards need to be prepared. Directors — who are charged with overseeing the long-term goals of their companies — must also understand how activists may look at the company’s strategy and short-term results. They must understand what tactics and tools activists have available to them. They need to know and understand what defenses the company has in place and whether to adopt other protective measures for the benefit of the overall organization and stakeholders. Some specific steps companies should take include:

- **Understand the company’s potential vulnerabilities.** Boards need to carefully review their business and strategy to identify any weak areas. Boards should be doing this irrespective of whether the company may be an obvious activist target, but they must also be mindful of whether specific areas of concern exist among its investor base. Underperformance, particularly as it relates to industry peers, is the easiest way to draw activists’ attention. Other lightning rods are large cash balances that could be returned to shareholders through dividends or stock buybacks, unrelated or underperforming divisions or business units that could be spun off, and other assets, such as real estate, that do not generate a sufficient current return and could be sold. Once vulnerabilities are identified, boards need to determine how to address them while focusing on what is in the best interests of all shareholders.
- **Understand the company’s defense profiles.** It is critical that boards assess what defenses the company has in place or that may be readily deployable. Many companies have become more vulnerable to an activist attack after having acceded to shareholder demands to de-stagger boards, eliminate poison pills, and give shareholders the right to vote by written consent and call special meetings. By the time activist investors approach a company, they have done hundreds or thousands of hours of homework. Boards that do not understand their company’s existing defensive profile prior to an activist overture are disadvantaged from the start.
- **Prepare for an activist approach.** Companies need to be prepared to respond to an activist overture. Understanding the activist’s objectives and carefully evaluating the activist’s proposal in a timely manner is critical. Companies should assemble a response team, which may include a small team of corporate officers, legal, financial and proxy advisors; and investor relations personnel, to develop a plan. Having a game plan in place that addresses various scenarios will lead to a more thoughtful, productive and effective response.
- **Know and engage your shareholders.** Knowing and engaging your shareholders has never been more important. Companies should regularly monitor and identify their shareholder base and trading activity of the

The top 10 institutional investors voted, on average, the same way as ISS 91 percent of the time and Glass Lewis 94 percent of the time

company's shares.¹² With the 10 largest shareholders of an S&P 500 company, on average, holding 44.7 percent of the company's stock,¹³ the support of major shareholders can make or break an activist campaign. Companies should make it part of their platform to reach out to significant shareholders, not only to better appreciate their perspectives on the company, but also to build credibility and stronger relationships. In addition to cultivating relationships with investors, companies must continually and effectively communicate their business strategies and plans for value creation to the marketplace. Companies should take advantage of the power of the Internet by making sure their Web sites are up to date and fully articulating the company's message. Companies should also actively monitor shareholder concerns and opinions that are expressed through blogs and other shareholder forums and proactively respond to shareholder issues before they escalate.

- **Determine director involvement.** As part of shareholder engagement, companies need to determine whether, and to what extent, directors should be communicating directly with shareholders on the company's behalf. According to PwC's annual survey, nearly seven-in-ten directors said their board regularly communicated with the company's largest investors during the past year, and 32 percent of directors reported that their board interacted with activists this past year.¹⁴ Director engagement is important to investors, and boards should consider establishing protocols and practices regarding permissible discussion topics for directors and shareholders, as well as a process for shareholders to request direct dialogue with the board. Approximately six-in-ten directors surveyed reported that their companies have either established or discussed such protocols and practices.¹⁵
- **Understand the influence of proxy advisory firms.** Proxy advisory firms — namely Institutional Shareholder Services (ISS) and Glass Lewis — significantly impact shareholder activist campaigns, with institutional investors often relying on the recommendations of these firms to assist them in voting all manners of proxy solicitation. A compilation of institutional investor voting in recent contested director elections revealed that the top 10 institutional investors voted, on average, the same way as ISS 91 percent of the time and Glass Lewis 94 percent of the time.¹⁶ Further, evidence suggests that a “no” recommendation from these firms results in a roughly 30 percent “no” vote by institutional shareholders.¹⁷ The fear and reality created by opposition from proxy advisory firms has led many companies to negotiate a settlement with the activists, which continues to be the most common way to resolve an activist campaign. But some companies do fight back — with this year's most notable being DuPont successfully taking on Trian Partners' campaign to install four new board members. While the vote was close, DuPont's existing board prevailed, given that several key shareholders ultimately rejected the advice of ISS and Glass Lewis.

3. Cybersecurity

Nearly 90 percent of CEOs worry that cyber threats could adversely impact growth prospects, up from nearly 70 percent the previous year.¹⁸ Yet, in a recent survey, nearly 80 percent of the more than 1,000 information technology leaders surveyed had not briefed their board of directors on cybersecurity in the last 12 months.¹⁹ The cybersecurity landscape has become more developed, and, as such, companies and their directors will likely face stricter scrutiny of their protection against cyber risk. Cyber risk — and the ultimate fallout of a data breach — should be of paramount concern to directors.

Risk management. One of the biggest concerns facing boards is how to provide effective oversight of cybersecurity. The following are questions that boards should be asking:

- **Governance.** Has the board established a cybersecurity review committee and determined clear lines of reporting and responsibility for cyber issues? Does the board have directors with the necessary expertise to understand cybersecurity and related issues?
- **Critical asset review.** Has the company identified what its highest cyber risks assets are (e.g., intellectual property, personal information and trade secrets)? Are sufficient resources allocated to protect these assets?
- **Threat assessment.** What is the daily/weekly/monthly threat report for the company? What are the current gaps, and how are they being resolved?
- **Incident response preparedness.** Does the company have an incident response plan, and has it been tested in the past six months? Has the company established contracts via outside counsel with forensic investigators in the event of a breach to facilitate quick response and privilege protection?
- **Employee training.** What training is provided to employees to help them identify common risk areas for cyber threat?
- **Third-party management.** What are the company's practices with respect to third parties? What are the procedures for issuing credentials? Are access rights limited and backdoors to key data entry points restricted? Has the company conducted cyber due diligence for any acquired companies? Do the third-party contracts contain proper data breach notification, audit rights, indemnification and other provisions?
- **Insurance.** Does the company have specific cyber insurance, and does it have sufficient limits and coverage?
- **Risk disclosure.** Has the company updated its cyber risk disclosures in SEC filings or other investor disclosures to reflect key incidents and specific risks?

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The SEC and other government agencies have made it clear that it is their expectation that boards actively manage cyber risk at an enterprise level. Given the complexity of the cybersecurity inquiry, boards should seriously consider conducting an annual third-party risk assessment to review current practices and risks.

Increased regulation. Directors should anticipate increased regulation for companies in the area of cybersecurity. The 3rd Circuit Court of Appeal's decision in the Federal Trade Commission's (FTC) suit against Wyndham Worldwide for a series of three data breaches—acknowledging the FTC's jurisdiction to regulate data security practices under its authority to regulate unfair and deceptive trade practices—will likely embolden the FTC in its role as de facto chief cybersecurity regulator.²⁰ Fortunately for defendants, such authority will not go unchecked, as evidenced by the dismissal of the FTC's action against LabMD.²¹

The SEC appears similarly emboldened in the area of cybersecurity, as 2015 was the SEC's most active year to date in setting out expectations regarding cybersecurity. The SEC Office of Compliance Inspections and Examinations (OCIE) issued multiple risk alerts and announced a new cybersecurity audit, and the Investment Management Division issued additional cybersecurity guidance. To make sure everyone was listening, the SEC announced an enforcement action against RT Jones, an investment advisor, pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 under Rule 30 of Regulation S-P for its "failure to adopt policies reasonably designed to protect customer records and information." Although there was no evidence that any client suffered financial harm, the investment advisor settled for \$75,000.

Increased litigation exposure. Responsibility, accountability and liability in connection with data breaches are not always clear. Indeed, as evidenced by Target's recent \$39 million settlement with certain major credit card brands, companies are fighting over who should be liable for exposure in a data breach. In October 2015, Visa/Mastercard/American Express and others shifted liability to the bank of merchants who failed to implement "smart chip" (EMV) technology to credit cards.

Class action liability to consumers is also broadening. In *Remijas v. Neiman Marcus Gp.*, the 7th Circuit reversed the district court's decision, ruling that Neiman Marcus customers whose credit card information was compromised had standing to bring a class action suit against the retailer.²² With dozens of lawsuits being filed within days of a major data breach, most major data breach class actions are now being transferred to the multidistrict litigation panel in federal court. All of these issues signal that the risks of getting cybersecurity wrong will likely cost companies millions (and potentially hundreds of millions) in losses.

Director liability. Directors of companies that experience major data breaches are often faced with derivative actions following an event. However, provided that boards have been actively engaged in monitoring their companies' efforts to avoid and mitigate such a breach, the risk of personal liability appears to be slim. In assessing whether directors have met their duty of due care, the court will "look for evidence of whether a board has acted in a deliberate and knowledgeable way, identifying and exploring alternatives."²³ In the most notable case to date, the derivative lawsuit against Wyndham Worldwide's board of directors was dismissed. The court held that the directors were not grossly negligent in conducting the investigation, noting key metrics for directors: Wyndham's board had

discussed the cyberattacks at 14 meetings during the relevant time frame, and the company's general counsel gave a presentation regarding the data breaches or data security at each meeting. The court also noted that the board's audit committee discussed these issues during at least 16 meetings over the same time period. Noting that the company had retained third-party technology firms to investigate each breach and recommend enhancements to Wyndham's systems, the court reasoned that the board had conducted a reasonable investigation.

International data transfers. Directors should also be aware of, and focus on, international data protection compliance. In late 2015, the European Court of Justice issued a landmark decision in *Schrems v. Data Protection Commissioner*, which invalidated the Safe Harbor that allowed for transfer of data between Europe and the United States.²⁴ Multinational companies faced a chaotic regulatory environment, with the U.S. Department of Commerce saying that it would still enforce the Safe Harbor and with some European Data Protection Authorities saying that they would prosecute companies transferring data from Europe to the United States in reliance on the now-invalidated Safe Harbor. European Union Justice Commissioner Vera Jourova has since announced that the European Union has "agreed in principle" with the United States on a new trans-Atlantic data transfer agreement. Directors should be aware of their companies' international data protection practices and the ever-changing regulatory landscape internationally.

The National Association of Corporate Directors' (NACD) five principles of cybersecurity are instructive to keep directors on top of mitigating cyber risk:

1. Directors need to understand and approach cybersecurity as an enterprisewide risk management issue, not just an IT issue.
2. Directors should understand the legal implications of cyber risks as they relate to their company's specific circumstances.
3. Boards should have adequate access to cybersecurity expertise, and discussions about cyber-risk management should be given regular and adequate time on board meeting agendas.
4. Directors should set the expectation that management will establish an enterprisewide risk management framework with adequate staffing and budget.
5. Board management discussion of cyber risk should include identification of which risks to avoid, accept, mitigate or transfer through insurance, as well as specific plans associated with each approach.

4. Risk Management

Risk management goes hand in hand with strategic planning — it is impossible to make informed decisions about a company's strategic direction without a comprehensive understanding of the risks involved. An increasingly interconnected world continues to spawn newer and more complex risks that challenge even the best-managed companies. How boards respond to these risks is critical, particularly with the increased scrutiny being placed on



boards by regulators, shareholders and the media. In a recent survey, directors and general counsel identified IT/cybersecurity as their number one worry, and they also expressed increasing concern about corporate reputation and crisis preparedness.²⁵ Below we highlight these top risks, which should be on the radar screens of all companies:

- **Cyber risk.** Cyber risk is not going away, so it is imperative that boards and management do what they can to manage and minimize cyber risk, as discussed more fully above in the discussion on cybersecurity.
- **Reputation risk.** The importance of reputation cannot be overstated. Warren Buffet once said, “It takes 20 years to build a reputation and five minutes to ruin it.” In the age of social media, those five minutes can now be as short as five seconds. This may explain why many companies view reputation risk as a top risk concern.²⁶ As part of its responsibility for overseeing risk management, the board plays a vital role in protecting a company’s reputation. There are differing schools of thought on whether reputation risk is a risk category in its own right or merely a consequence of a failure to manage other risks effectively. A company may do everything right and still take a hit to its reputation from unfounded rumors or other totally exogenous sources. But, in most instances, reputational damage is triggered by some other business or operational risks, including risks relating to the quality or safety of the company’s products or services, or illegal, unethical or questionable corporate conduct of which the public was not aware.²⁷

The consequences of reputation risk can quickly escalate to a prolonged crisis, involving losses in revenue, customers, brand value and market value, regulatory investigations and civil liabilities and fines. Because reputation is such a vital asset and is so intertwined with other risks that a company faces, it is important that the company’s risk appetite appropriately takes reputation risk into account.

- **Crisis management.** A failure to manage risks effectively can easily lead to a crisis for a company. Large companies can expect to face a crisis, on average, every four to five years.²⁸ Rightfully so, directors are increasingly concerned with the impact that an unexpected crisis could have on their organization. In PwC’s annual survey, 27 percent of directors described their board’s performance in crisis management preparedness as needing improvement.²⁹ The board must prepare for the range of events that could impact the company, and ensure that the company has an adequate plan in place to respond to a crisis. A crisis can take many forms. Some may be gradual, such as emerging competitive threats or an economic downturn. Others are abrupt, such as a cyber attack, fraud allegations, technology failure or natural disaster. In a recent survey of in-house counsel, respondents, on average, said that it would take approximately 38 hours for their companies to activate a social media crisis response.³⁰ When a crisis hits, time is at a premium. Companies need to have an effective crisis response plan that identifies a team responsible for internal and external communications, and also identifies external legal and investor relations experts that can help the company respond quickly and effectively.

Given the wide spectrum of risks that most companies face, it is critical that boards evaluate the manner in which they oversee risk management. Most companies delegate primary oversight responsibility for risk management to the audit committee. Of course, audit committees are already burdened with a host of other responsibilities that have increased substantially over the years. According to Spencer Stuart, 12 percent of boards now have a stand-alone risk committee, up from 9 percent last year.³¹ Even if primary oversight for monitoring risk management is delegated to one or more committees, 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. Also, if primary oversight responsibility for particular risks is assigned to different committees, collaboration among the committees is essential to ensure a complete and consistent approach to risk management oversight.

5. Social Media

Companies that ignore the significant influence that social media has on existing and potential customers, employees and investors do so at their own peril. Last quarter, Facebook reported daily active users (DAUs) of 1.01 billion on average for September 2015, an increase of 17 percent year over year and mobile DAUs of 894 million on average for September 2015, an increase of 27 percent year over year.³² Twitter reported 66 million average monthly active users in the United States in the third quarter of 2015 and 254 million in the rest of the world, which represents increases of 4 percent and 13 percent, respectively, from the prior year.³³ This ubiquitous connectivity has profound implications for businesses.

Many companies are using social media marketing to enhance product and brand awareness, promote corporate strategy and reputation, build customer loyalty and encourage customer engagement, all of which can drive revenues. Moreover, customers increasingly post reviews of products, brands and companies, and research shows that social recommendations induce an average of 26 percent of purchases.³⁴ With customers increasingly participating in online conversations about their “likes” and experiences, and more and more would-be customers checking out those recommendations before making a purchase, it is critical that companies become part of the online community and connect with customers in meaningful ways.

However, in addition to understanding and encouraging changes in customer relationships via social media, directors need to understand and weigh the risks created by social media. These risks include harm to a company’s reputation when a post goes “viral,” particularly if the company has an inadequate or delayed response, as well as risks created by the use of mobile technologies and social media by company personnel and posting confidential or proprietary information to a social media platform. According to a recent survey, 91 percent of directors and 79 percent of general counsel surveyed acknowledged that they do not have a thorough understanding of the social media risks that their companies face.³⁵

As part of its oversight duties, the board of directors must ensure that management is thoughtfully addressing the strategic opportunities and challenges posed by the explosive growth of social media by probing management’s knowledge, plans and budget decisions regarding these developments. Given new technology and new social media forums that continue to arise, this is a topic that must be revisited regularly.

Companies that ignore the significant influence that social media has on existing and potential customers, employees and investors do so at their own peril

Global M&A activity exceeded \$3.2 trillion in the first three quarters of 2015

Thomson Reuters

6. M&A Developments

M&A activity has been robust in 2015 and is on track for another record year. According to Thomson Reuters, global M&A activity exceeded \$3.2 trillion, with almost 32,000 deals during the first three quarters of 2015, representing a 32 percent increase in deal value and a 2 percent increase in deal volume, compared to the same period last year.³⁶ The record deal value mainly results from the increase in megadeals over \$10 billion, which represented 36 percent of the announced deal value, particularly in the health care and life sciences sectors.³⁷ While there are some signs of a slowdown in certain regions based on deal volume

in recent quarters, global M&A is expected to carry on its strong pace in the beginning of 2016. To help directors prepare for possible M&A activity in the future, we highlight below recent M&A developments for boards to consider:

- **Delaware case law developments.** The Delaware courts churned out several noteworthy decisions in 2015 regarding M&A transactions that should be of interest to directors, including decisions on the court's standard of review of board actions, exculpation provisions, appraisal cases and disclosure-only settlements:

- **Business judgment rule.** In its first test of the deferential deal process standard relating to when the business judgment standard of review will be applied in controlling stockholder buyouts, as set forth in *Kahn v. M&F Worldwide*³⁸ (the MFW standard), the Delaware Supreme Court recently affirmed in the SynQor case³⁹ the Court of Chancery's earlier ruling dismissing a shareholder suit because the controlling buyout transaction met the MFW standard for business judgment review. Based on this decision, it seems that the MFW standard can provide boards with a relatively predictable way to ensure business judgment review, except in circumstances involving fraud, as discussed below.

Interestingly, in the recent Dole case,⁴⁰ the Court of Chancery decided that, while the process for obtaining approval from the board technically followed the MFW standard, the misleading information that the Dole CEO and COO purposely provided to the board undermined the fairness of the process, and therefore, the court applied the entire fairness standard of review instead. The court also held that, although the final merger price was "arguably fair," the stockholders were entitled to a "fairer price" because of the fraud.

In addition, in *Corwin v. KKR Financial Holdings*,⁴¹ the Delaware Supreme Court clarified that in situations where entire fairness review does not apply (because the transaction did not involve a controlling stockholder), the fully informed, uncoerced approval of the disinterested stockholders invokes the business judgment rule standard of review instead of the heightened standards under *Revlon* or *Unocal*, even if that vote is required by statute.

- **Exculpation.** The Delaware Supreme Court held in *In re Cornerstone Therapeutics Inc. Stockholder Litigation*⁴² that a claim solely for monetary damages against a disinterested and independent director of a corporation with an exculpatory charter provision, which provides that a director cannot be personally liable for damages resulting from breaches of the duty of care, can be dismissed regardless of the underlying standard of review (including in interested transactions subject to entire fairness review), unless the plaintiff has alleged facts to support an inference of disloyalty with respect to that director. This decision reversed the 2014 decisions in the Cornerstone Therapeutics and Zhongpin cases⁴³ and removed the resulting disincentive for independent directors to negotiate transactions with controlling stockholders.
- **Appraisal cases.** In several recent appraisal cases,⁴⁴ the Delaware courts have generally found that the merger price was the most reliable indicator of fair value.⁴⁵ These decisions confirm the courts' reluctance to substitute their own calculation of the "fair value" of a target company's stock, including through a discounted cash flow analysis, for the purchase price derived through arm's-length negotiations, as long as that price resulted from a thorough, informed and disinterested sales process.
- **Disclosure-only settlements.** Recently, the Court of Chancery seems to be reconsidering its prior practice of approving disclosure-only settlements involving a broad release of claims and payment of attorney fees in connection with stockholder suits brought over merger transactions. While it has continued to approve several of these settlements,⁴⁶ it has also rejected other proposed settlements or reserved judgment,⁴⁷ and, in *In re Riverbed Technology, Inc. Stockholders Litigation*,⁴⁸ the court warned that, going forward, it would no longer grant broad releases in return for disclosure-only settlements and attorney fees. Since then, in *In re Aruba Networks, Inc. Shareholders Litigation*,⁴⁹ the court declined to approve such a disclosure-only settlement and, for the first time, also dismissed a case on the basis of inadequate representation by counsel.

This uncertainty surrounding the approval of disclosure-only settlements may be having an impact on merger litigation. According to recent analysis by *The Chancery Daily*, the number of new merger objection lawsuit filings in the Chancery Court has begun to drop, which could be, at least in part, due to these recent

rulings.⁵⁰ It will be interesting to see if this trend continues, and if so, the effect it may have on merger litigation, such as shifting such litigation to other jurisdictions. Or, if courts do not approve disclosure-only settlements, companies that would have otherwise quickly entered into such settlements and paid the related attorney fees could possibly end up mired in costly and time-consuming litigation.

- **Representation and warranty insurance.** The use of representation and warranty insurance (R&W insurance) has risen exponentially over the past few years, and this trend is expected to continue into 2016. While R&W insurance used to be a way to differentiate a buyer's bid, buyers may now be at a competitive disadvantage if they do not use R&W insurance, particularly in middle-market transactions.⁵¹ R&W insurance typically provides coverage for a buyer's indemnification claims for losses resulting from a seller's breach of representations and warranties made in an acquisition agreement, allowing parties to shift some of the business risks to an insurer. Either the buyer or the seller can obtain R&W insurance, but buy-side policies are more customary than sell-side policies. The increased use of R&W insurance results from improved and more standardized terms (including longer policy periods, higher coverage limits and narrower exclusions), lower premiums, and greater acceptance and awareness among insurers and potential insureds. Boards are advised to familiarize themselves with the general terms and conditions of R&W insurance and to stay informed about this developing product.

7. Board Composition and Succession Planning

Boards have to look at their composition and make an honest assessment of whether they collectively have the necessary experience and expertise to oversee the new opportunities and challenges facing their companies. Finding the right mix of people to serve on a company's board of directors, however, is not necessarily an easy task, and not everyone will agree with what is "right."

According to Spencer Stuart's 2015 Board Index, board composition and refreshment and director tenure were among the top issues that shareholders raised with boards.⁵² Because any perceived weakness in a director's qualification could open the door for activist shareholders, boards should endeavor to have an optimal mix of experience, skills and diversity, as well as a long-term board succession plan, in place.

At the 22 S&P 500 companies led by a woman, women directors comprise 28 percent of all board members, while women comprise just 19 percent of directors of companies with male CEOs

- **Board composition.** To better align board composition with company needs, a board's nominating and governance committee should first determine the specific talents and experiences that they believe will help the company achieve its strategic plan and manage its risk profile. Once the right mix is determined, the committee should identify any gaps in the current board composition. Based on PwC's annual survey, directors continue to view financial, industry and operational expertise as the most important director attributes, with risk management, international, cybersecurity and IT expertise following closely behind.⁵³

The ability to think holistically and work with people are personal attributes that are wholly underrated. These personal characteristics, together with other intangible qualities, such as leadership, trustworthiness, good judgment and diversity of thought, whether age, race, religion or gender, must be considered when building an effective board. Many companies say they are committed to achieving a diversified board; however, the percentage of female and minority directors serving on U.S. boards is disproportionately quite low, with women accounting for approximately 20 percent of independent directors on S&P 500 company boards, and minority directors accounting for just 15 percent of all directors at S&P 200 companies.⁵⁴ Many companies claim that a shortage of qualified candidates limits their ability to diversify. It is interesting to note, however, that, at the 22 S&P 500 companies led by a woman, women directors comprise 28 percent of all board members, while women comprise just 19 percent of directors of companies with male CEOs.⁵⁵

Director tenure is another board consideration that has made its way into the spotlight. Seventy-five percent of S&P 500 companies have established a mandatory retirement age for directors, with half setting the retirement age at 72.⁵⁶ Only three percent of S&P 500 companies have actual term limits for directors.⁵⁷ In the past few years, shareholder groups have argued that long-tenured directors are more likely to align with management, thereby compromising the directors' independence and making it difficult for companies to refresh their board members. ISS' Governance Quickscore now considers the percentage of nonmanagement directors who have served on the board for more than nine years, indicating that such tenure potentially compromises a director's independence. Some investors also view long tenure as problematic. The Council of Institutional Investors (CII) and the California Public Employees' Retirement System (CalPERS) include director tenure as a factor that boards should consider when determining whether a director is independent.⁵⁸ And State Street Global Advisors adopted a policy to vote against long-tenured directors and nominating committee members in companies it identifies as needing "board refreshment."⁵⁹ These types of policies may facilitate board refreshment, but they do so at the risk of losing some of the most savvy and skilled directors with highly valued firm knowledge, expertise or perspectives.

Rather than using a director's age and tenure as the means to board refreshment, boards should renew their focus on the board evaluation process. Board evaluations are intended to provide insight and help boards improve their functions. Yet, too often, these evaluations are completed so that boards can check-the-box for compliance purposes, rather than attain thoughtful consideration on ways to improve board and director effectiveness. Utilizing an outside third party to interview the board, and conducting individual or peer evaluations, are both powerful tools that boards can use to attain valuable feedback and improve board effectiveness.

- **Board succession.** In light of the importance placed on board composition, it is critical that boards have a long-term board succession plan in place. Boards need to be prepared not only for scheduled retirements, but for unexpected departures, shareholder pressures, gaps in skills and expertise, and underperforming board members. Addressing an underperforming director is a delicate issue, but nearly 40 percent of directors in PwC's annual survey opined that someone on their board should be replaced, citing diminished performance due to aging, lack of preparation and/or lack of expertise as primary reasons for dissatisfaction.⁶⁰

To properly plan for board succession, directors should regularly identify and evaluate potential candidates against the board's needs. Existing board members, senior management and search firms are often the best resources for identifying individuals who may be a good fit for the board. Many boards search for candidates with similar skills or experiences as the director exiting the board, but replacing "like with like" does not necessarily make for an effective succession plan. Boards need to ensure that a director candidate has the experience and expertise that the board needs, along with a personality that would likely fit with the culture and dynamics of the board. The larger the pool of candidates a board has to consider, the more likely the board will find the right person for the job. Boards that take this proactive approach are able to find better candidates and respond faster and more effectively when an activist approaches or an unforeseen vacancy occurs.

8. Audit Committees

Averaging 8.8 meetings a year, audit continues to be the most time-consuming committee.⁶¹ Audit committees are burdened not only with overseeing a company's risks, but also a host of other responsibilities that have increased substantially over the years. Prioritizing an audit committee's already heavy workload and keeping directors apprised of relevant developments will be important as companies prepare for 2016. We highlight below just a few of such developments that audit committees should have on their radars:

- **Enhanced audit committee disclosures.** In July 2015, the SEC issued a concept release seeking comment on whether additional disclosures should be required on how audit committees work and how they engage and oversee the company's independent auditor. Emphasizing the importance of the audit committee's oversight of the auditor, the disclosure would require companies to disclose more information about their process and

criteria for selecting an outside auditor, how often they meet with the auditor and how they review the auditor's performance. At the same time, the Public Company Accounting Oversight Board (PCAOB) issued a concept release focusing on possible indicators of audit quality and whether such information would be useful to stakeholders. The SEC and PCAOB are still poring over the comments they received on these releases, but many companies, encouraged by initiatives of regulators, investors, corporate governance leaders and other stakeholders, have already begun significantly increasing their voluntary proxy statement disclosures.⁶² For the 2015 proxy season, the pension fund of the United Brotherhood of Carpenters sent letters to 91 S&P 500 companies, seeking enhanced disclosures relating to the audit committee's ownership and oversight of the audit relationship.⁶³ And BlackRock's 2015 proxy vote guidelines indicate that it looks to a company's audit committee report for insight into the scope of the audit committee's responsibilities.⁶⁴ In light of these developments, audit committees should consider enhancing their audit committee reports and related proxy statement disclosures by providing more robust information on the audit committee's processes and activities.

- **Developments in accounting rules.** Audit committees need to stay abreast of accounting changes that are on the horizon and understand the implications they may have, not only on a company's financial reporting and accounting, but also on a company's IT systems and data and accounting processes and controls. One such change is the principles-based standard of revenue recognition finalized in 2014 by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), which will change the way many companies recognize revenue from customer contracts. The effective date of the new revenue recognition standard was recently delayed by one year and will now apply for annual reporting periods beginning after December 15, 2017. FASB also recently voted to move forward with new lease accounting standards that would require companies to include lease obligations on their balance sheets, a majority of which are not currently reported on a lessee's balance sheet. These new standards still require final approval and would not take effect until 2019. If adopted, however, the new standards will likely require changes to company lease systems and related controls, as well as revisions to financial covenants in debt instruments to avoid inadvertent defaults. Audit committees need to monitor these and other accounting changes on the horizon so that they are prepared for how such rules could impact the company going forward.
- **Increased scrutiny.** The SEC's Division of Enforcement has renewed its focus on financial reporting of public companies and is more closely scrutinizing internal controls and the audit committee's engagement of external auditors. Audit committees should understand the SEC's investigation and enforcement process so that they are aware of what arouses the suspicions of securities regulators. The SEC's Financial Reporting and Audit Task Force uses a variety of tools and data analytics when reviewing a company's financial statements, including the Corporate Issuer Risk Assessment Program, which is a database of public company filings programmed to flag certain identified factors and events for the SEC's investigation team to review. Companies in particular industries or sectors (especially where foreign operations are involved), companies whose financial statements have indicated unusual growth, and companies that have recently changed auditors or made late SEC filings are likely to raise a flag. The goal of the Task Force is to proactively identify financial reporting irregularities and internal control weaknesses so that companies can remedy such weaknesses before inaccurate financial statements are prepared.

Boards can also expect greater scrutiny of the process and factors used when engaging and retaining external auditors. Audit committees should assess individual members of any audit team to ensure that such individuals possess the necessary skills and experience for their company. The audit team needs to understand the economic landscape of the company, as well as its business and industry, both on a regional and global level. Before engaging an auditor, the audit committee should carefully consider the auditor's technical competence, as well as the auditor's objectivity and independence and how each may affect the auditor's scrutiny of information throughout audit. Audit committees should also discuss with the auditor the audit team's approach to internal quality control issues and inquiries and comments from regulators in inspection reports.

9. Executive and Director Compensation

Perennially in the spotlight, executive compensation will continue to be a hot topic for directors in 2016. But this year, due to the SEC's active rulemaking in 2015, directors will have more to fret about than just say-on-pay. Roughly five years after the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted, the SEC finally adopted the much anticipated CEO pay ratio disclosure rules,⁶⁵ which have already begun stirring the debate on income inequality and exorbitant CEO pay. The SEC also made headway on other Dodd-Frank regulations, including proposed rules on pay-for-performance,⁶⁶ clawbacks⁶⁷ and hedging disclosures.⁶⁸ We highlight below some of the matters that directors should be considering as they craft executive compensation for 2016, particularly in light of the SEC's recent rulemaking.

Just when companies thought the spotlight on CEO pay could not get any brighter, here come the SEC's CEO pay ratio disclosure rules. These rules require companies to disclose the annual total compensation of the CEO, the median of the annual total compensation of all employees other than the CEO and the ratio of these two numbers, arguably to give shareholders more context on how a company pays its executives. Although this disclosure does not kick in for most companies until their 2018 proxy statements (relating to compensation for the 2017 fiscal year), companies should not unnecessarily delay consideration of the significant steps that will be required to ensure compliance with the new rule.

The SEC generously provided companies with certain latitude regarding how the median employee is identified, including allowing statistical sampling of the employee population and providing exemptions for certain non-U.S. employees, as well as flexibility on choosing a testing date. But despite this latitude, compliance with the new rule likely will be burdensome and costly, particularly for large or multinational companies where the information to be collected will be extensive. To take advantage of the flexibility that the rules provide, companies need to determine which methodology will work best for their organizational structure and what assumptions and adjustments will need to be made, whether any non-U.S. employees will be exempt, and also what testing date might be most advantageous.

CEO pay ratios are already making headlines, with Discovery Communications topping the charts at a hefty 1,951-to-1 ratio, and the average CEO earning 204 times the median employee based on a recent study by Glassdoor.⁶⁹ Because pay ratios will attract extensive media coverage, the sooner companies have a grasp of what their pay ratio will look like, the better. Directors need to think about how they will explain the pay disparity between their CEO and employees, including any assumptions or adjustments the company may need to make. Being able to explain why the CEO's compensation is what it is will be paramount. Not only will this explanation be important for investors, but boards also need to be concerned about how company employees will react to this information. Disclosing the median worker's salary could create tensions among workers, who will now realize how their salary compares to others, not only within their organization, but with competitors as well. Citing various distinguishing factors, such as the fact that the company employs a significant number of minimum wage employees or that its competitors outsource low-paying positions, may help dispense any unintended rifts within the organization.

With the pay ratio rules center stage, companies should remain mindful of certain other Dodd-Frank rules that the SEC proposed over the past year, which, if adopted in the near future, could very well take effect before the pay ratio rules. Companies need to start planning how they will implement and comply with these rules once adopted:

- **Pay for performance.** The SEC proposed pay-for-performance rules in April 2015, which call for companies to disclose in their annual proxy statements the relationship between executive compensation and the company's financial performance. Although final rules have not yet been adopted, most companies are already paying closer attention to pay-for-performance alignment. Nearly 60 percent of public companies have conducted an executive-pay-for-performance analysis comparing the company's performance and executive pay with those of its peers in the marketplace, but only one third of such companies have disclosed the findings of their analysis.⁷⁰

- Clawbacks.** The SEC proposed clawback rules in July 2015, which call for stock exchanges to require listed companies to adopt clawback policies for the recovery of excess incentive-based compensation if the company is required to prepare an accounting restatement resulting from material noncompliance with any financial reporting requirement. The proposed rules are broader than the clawback provisions in the Sarbanes-Oxley Act, which apply to only the CEO and CFO, have only a one-year lookback and require misconduct. While some companies are waiting to see what the final rules look like before adopting a policy, those companies that have a clawback policy should review it for changes that are likely to be required. Companies should also take inventory of their compensation plans or arrangements that may be subject to clawbacks and consider whether amendments to such plans will be necessary to address clawbacks.
- Hedging.** The SEC proposed hedging disclosure rules in February 2015, which call for companies to disclose in their annual proxy statements whether the company permits its employees, officers or directors to hedge or offset any decrease in the market value of the company's equity securities. With the negative light that ISS and Glass Lewis have cast on hedging (and pledging) by executive officers, an increasing number of companies already have adopted policies that prohibit hedging and, pursuant to existing CD&A requirements, disclosed such policies in their proxy statements.

Directors are also reminded to take extra care when determining their own compensation. Earlier this year, the Delaware Chancery Court, in *Calma v. Templeton*,⁷¹ declined to dismiss a claim against members of Citrix Systems, Inc.'s board that they breached their fiduciary duties by awarding themselves equity grants that the plaintiffs claimed were "excessive" in comparison to compensation received by directors at Citrix's peers and amounted to corporate waste. The defendants argued that awards were made under an equity plan that had been approved by stockholders and that the board should be given the deference of the business judgment rule. The plan, however, did not set forth specific compensation to be granted to nonemployee directors, but rather gave the board broad discretion to determine the amounts and terms of awards, subject to certain general annual limits. Relying on *Seinfeld v. Slager*,⁷² the court held that, although stockholders approved the equity plan under which the equity was awarded, the plan did not include enough specificity on the amount or form of compensation to be issued to the nonemployee directors for stockholder ratification to occur. There must be some meaningful limit imposed by the stockholders on the board of directors for the awards to be evaluated under the business judgment rule. Because there were no such limits, the board's decision was subject to review under the more exacting entire fairness standard, which requires the board to prove the fairness of the awards to the company.

10. Proxy Access

2015 was a turning point for shareholder proposals seeking to implement proxy access, which gives certain shareholders the ability to nominate directors and include those nominees in a company's proxy materials. During the 2015 proxy season, the number of shareholder proposals relating to proxy access, as well as the overall shareholder support for such proposals, increased significantly. Indeed, approximately 110 companies received proposals requesting the board to amend the company's bylaws to allow for proxy access, and, of those proposals that went to a vote, the average support was close to 54 percent of votes cast in favor, with 52 proposals receiving majority support.⁷³ New York City Comptroller Scott Springer and his 2015 Boardroom Accountability Project were a driving force, submitting 75 proxy access proposals at companies targeted for perceived excessive executive compensation, climate change issues and lack of board diversity. Shareholder campaigns for proxy access are expected to continue in 2016. Accordingly, we set forth below certain considerations for boards if faced with such a shareholder proposal in the future:

- Typical proxy access provisions.** Although market practice continues to develop, certain features of proxy access proposals are

2015 was a turning point for shareholder proposals seeking to implement proxy access

emerging as typical. Based on proxy access bylaw provisions adopted in 2015, the most common ownership threshold for nominating shareholders is 3 percent of a company's outstanding common shares for at least three years, with ownership being tied to possessing full voting and investment rights of such shares, as well as the full economic interest. Most companies have limited the number of board seats available to proxy access to 20 percent of the board, and the most typical limit on the number of shareholders that may comprise a nominating group is 20.

- **The role of institutional investors and proxy advisory firms.** Because institutional investors and proxy advisory firms are able to impact the outcome of a proxy access proposal, it is important for directors to understand the positions that such investors and firms have when determining how best to address proxy access:
 - **Institutional investors.** Proxy access is supported by many leading institutional investors, including New York City Pension Funds, CalPERS, TIAA-CREF, California State Teachers' Retirement System (CalSTRS), T. Rowe Price and Vanguard. In fact, a report by Broadridge and PwC found that institutional investors are four times more likely to support proxy access than retail investors.⁷⁴ Additionally, CII has adopted best practice guidelines for proxy access provisions, which identify features of proxy access that it would consider troublesome if adopted by a company. These features include ownership thresholds of 5 percent or more, provisions that could result in fewer than two proxy access nominees and a limit on the number of shareholders that could be aggregated to form a nominating group.
 - **Proxy advisory firms.** Proxy advisory firms generally favor proxy access as well. ISS will generally recommend in favor of proxy access proposals that have an ownership threshold of no more than 3 percent of the voting power, a holding period of no more than three years, minimal or no limits on the number of shareholders that may comprise a nominating group, and no less than a 25 percent cap on the number of proxy access board seats. Further, ISS will recommend a vote against directors if a company does not include a proxy access proposal that was properly submitted and was not voluntarily withdrawn by the proponent or excluded pursuant to SEC no-action relief (discussed below) or a federal court ruling. Glass Lewis reviews proxy access proposals on a case-by-case basis, but generally supports proxy access as a means to ensure that "significant, long-term shareholders have an ability to nominate candidates to the board."
- **SEC no-action relief.** During the 2015 proxy season, the SEC threw a curveball to companies by suspending for the 2015 proxy season the use of Exchange Act Rule 14a-8(i)(9), which allows companies to exclude a shareholder proposal that "directly conflicts" with a management-sponsored proposal. This rule was suspended in the wake of controversy surrounding no-action relief that the SEC initially granted (and later reversed) to Whole Foods Market, Inc., who had included a management-sponsored proxy access proposal with significantly higher thresholds than those included in the shareholder proposal that it had received. The SEC recently issued guidance on the future application of Rule 14a-8(i)(9), providing that no-action relief will be granted pursuant to this rule only "if a reasonable shareholder could not logically vote in favor of both proposals, i.e., a vote for one proposal is tantamount to a vote against the other proposal." Going forward, this narrow interpretation of Rule 14a-8(i)(9) will make it much more difficult for companies to exclude proxy access proposals on this basis.

Companies that implement their own form of proxy access may be able to exclude a proxy access shareholder proposal pursuant to Exchange Act Rule 14a-8(i)(10), which allows an exclusion if the company has already "substantially implemented" the proposal. However, if the company's proxy access provision diverges too far

in any material respect from the shareholder proposal, the SEC may very well determine that the proposal has not been substantially implemented and deny no-action relief.

- **Developing a strategy.** How boards address proxy access will depend on a number of factors, including the company's performance, size, shareholder base and board composition. At a minimum, directors should stay up to speed on proxy access terms and trends and review how companies are responding to proxy access proposals. Boards should consider the company's shareholder base and understand the positions of the company's institutional investors to determine the likelihood of success of a proxy access proposal if received. Directors should also engage company shareholders to ensure that the board understands their concerns and trigger points.

While some boards have preemptively adopted proxy access, most companies seem to be waiting until shareholders initiate proxy access. Taking the wait-and-see approach allows more time for market practices to develop and for boards to better understand proxy access and its implications. Preemptively adopting proxy access, however, could give the board more control over the terms included in the bylaw provision and may allow the company to exclude future shareholder proposals based on the "substantially implemented" exclusion discussed above.

Companies that receive a shareholder proposal have several alternatives, including (a) submitting the proposal to shareholders with an opposing, neutral or supporting board statement; (b) submitting a competing management proposal, an approach taken by seven companies in 2015 despite being potentially confusing for shareholders; (c) negotiating with the shareholder to withdraw in exchange for the company's commitment to adopt proxy access; or (d) seeking SEC no-action relief as discussed above.

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