CORPORATE ALERT

TOP 10 TOPICS FOR DIRECTORS IN 2007

2007 is shaping up to be a year in which directors of public companies will have lots to talk about. Here is our top 10 list of hot topics for the boardroom.

MERGERS AND ACQUISITIONS

1. Strong M&A Activity to Continue. 2007 is expected to be another robust year for mergers and acquisitions, perhaps even topping 2006’s record performance in which M&A deals totaled $3.79 trillion worldwide (up 38 percent from 2005) and there were 55 transactions valued at $10 billion or more.1 The ready availability of capital, low interest rates, a strong world economy, benign antitrust scrutiny and the receptivity of many companies to buyout proposals in the wake of Sarbanes-Oxley are fueling the surge in acquisitions. With hordes of financial buyers in the market, companies seeking to grow their businesses through strategic acquisitions are facing stiff competition for deals. At the same time, all companies should be assessing their own vulnerability to a takeover threat.

2. The Rising Role of Private Equity. There is a new force in the M&A market — private equity. Last year, private equity firms were involved in 20 percent of global deals and 27 percent of U.S. deals.2 Through “club” deals and partnering with strategic buyers, private equity firms have been able to target ever larger companies. Last year they were involved in five of the 10 largest U.S. transactions.3

While private equity buyouts should continue to dominate the M&A news in 2007, there are signs that these deals may face tougher sailing. In October 2006 the Justice Department commenced an investigation that appears to be focused on whether buyout firms are colluding to keep bids low, and institutional investors have started complaining about inadequate buyout prices.4 Nevertheless, with pressure on private equity firms to deploy their capital, it is a sellers’

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1 The figures reported are from Thomson Financial.
2 Id.
3 Id.
market. By some estimates, the private equity shops have $750 billion of cash at their disposal. Companies that are weary of the regulatory requirements and other pressures of being a public company should consider taking advantage of the attractive multiples being offered before interest rates rise or the economy turns and private equity firms find it more difficult to access the debt markets. On the other hand, companies wanting to remain public might wish to consider proactively deterring unsolicited offers by borrowing a page or two from the private equity playbook and leveraging their balance sheets to free up cash for stock buybacks or new projects that increase shareholder value.

CORPORATE GOVERNANCE

3. More Hedge Funds at the Gate. Activist hedge funds managed to garner plenty of attention from Corporate America in 2006 and will continue to do so in 2007. Seeking primarily to boost short-term share prices rather than take over a company, activist hedge funds typically buy at least a 5 percent stake in a company so as to trigger a Schedule 13D filing and then seek to influence corporate policy by pushing their own agenda to improve shareholder value, whether it be through seeking a divestiture of assets or non-core businesses, a sale of the company, increased dividends or a change in management. After the initial Schedule 13D is filed, a “wolf pack” of other hedge funds often will acquire stakes in the target company.

Often, hedge funds will wage or threaten to wage proxy fights to gain board seats or otherwise generate support for their proposals. This hedge fund strategy has been remarkably successful, with management acquiescing to some or all of the funds’ proposals at least 60 percent of the time. With the proliferation of hedge funds (there are now more than 8,000, compared to 5,000 in 2002) and more than $1.2 trillion in assets under management, it is inevitable that more activist hedge funds will enter the fray. The growing practice of some hedge funds to vote shares they borrow for a fee from brokerage firms and institutional fund managers may further compound this challenge.

Public companies should be assessing their vulnerability to a hedge fund attack. They should make sure that their business strategy is well articulated and effectively communicated to the marketplace. They should be carefully monitoring their shareholder base and any unusual trading activity, and they should have in place a response plan if a hedge fund attack occurs.

4. Looming Seismic Shift Towards Shareholder Democracy. Three recent developments have the potential of dramatically increasing shareholder say in the director election process. First, beginning in July 2007 companies and shareholders will be able to take advantage of new SEC rules that allow the distribution of proxy materials over the Internet. The availability of “e-proxy” will significantly reduce the printing and mailing costs for proxy solicitations and thereby eliminate a major barrier to mounting a proxy contest. It will also make it easier for insurgents to run a “short slate” in director elections, whereby shareholders nominate fewer directors than those standing for election.

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7 “Hedge Funds and Shareholder Activism,” The Altman Group Advisor (The Altman Group, New York, N.Y.), December 2006, at 1-2. (The Altman Group reports that of 75 instances of threatened or actual proxy contests by hedge funds tracked in 2006, the hedge funds were successful 60 percent of the time either through an actual contest or in a negotiated settlement). April Klein & Emanuel Zur, “Hedge Fund Activism” (European Corporate Governance Inst., Finance Working Paper 140/2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913362. (Klein and Zur report that in a study of Schedule 13D filings by hedge funds from January 2003 through December 2005, hedge funds had a 72 percent success rate (30 of 41) when they stated a demand for board representation, and a 60 percent success rate with respect to achieving some or all of their demands made in the initial Schedule 13D filings.)
Second, commencing in 2008 the NYSE is proposing to eliminate broker discretionary voting in the election of directors. Under current NYSE rules, brokers are permitted to vote shares held in client accounts on “routine” matters at their discretion absent voting instructions from the client. Under the proposed rule change, an uncontested director election would no longer be considered “routine.” Because brokers historically have used their discretion to vote in favor of management candidates, the rule change will make it more difficult to achieve a majority vote in companies that have adopted some form of majority voting policy (discussed below). The proposed rule change, which still must be approved by the SEC, would take effect January 1, 2008. Because the rule applies to brokers who are NYSE members, the rule change will affect not only NYSE-listed companies but also all other public companies.

Finally, the corporate world is anxiously awaiting the SEC’s response to a recent court decision that effectively allows shareholders to require companies to include shareholder nominees on management’s proxy. In September 2006 the 2nd Circuit held that an SEC rule that permits companies to exclude from their proxy statements shareholder proposals that relate to an election of directors does not allow a company to exclude a proposal relating to general procedures concerning director elections. Thus, the company in question, AIG, was required to include in its proxy statement a shareholder proposal to amend the company’s bylaws to require the company to include in the AIG proxy statement and proxy card shareholder-nominated candidates for director. In reaching its decision, the court rejected the SEC’s interpretation of the rule that it had followed in no-action letters since 1990 in favor of a 1976 SEC statement concerning the rule.

The SEC responded immediately to the decision by announcing that it would consider a rule change. However, signaling a lack of consensus among the commissioners, the SEC has twice postponed consideration of the matter, and SEC Chairman Cox recently indicated that the Commission will not address the issue in time for the 2007 proxy season. With the SEC failing to take action, the 2007 proxy season will likely feature shareholder proposals for bylaw amendments allowing shareholder access to management’s proxy statement in election contests. Hewlett-Packard, which is in the 9th Circuit, has elected to include a shareholder access bylaw proposal in its 2007 proxy statement after the SEC on January 22, 2007, declined to express a view as to whether the company could exclude the proposal from the company’s proxy statement. If the SEC fails to implement rules overturning the 2nd Circuit decision, we will see a dramatic change in the director election process, particularly when coupled with the availability of e-proxy and the elimination of broker voting in director elections.

5. Majority Voting Momentum. Majority voting in director elections was the hottest topic on the ballot during the 2006 proxy season and will again be the most common shareholder proposal during 2007. As of January 18, 2007, ISS was already tracking 104 shareholder proposals on the topic, and more than a dozen shareholder proposals had been withdrawn as companies acquiesced to majority voting requests.

During 2006 more than 180 companies adopted new policies or bylaws moving away from the plurality voting standard. According to ISS, 84 majority vote shareholder proposals came to a vote in the first half of 2006 (compared

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to 54 in the first half of 2005), and the average level of support was 47.7 percent (compared to 44.3 percent in 2005).\textsuperscript{11} Moreover, 36 proposals received more than 50 percent support, nearly triple the number in 2005.\textsuperscript{12}

Many companies are not waiting for receipt of a shareholder proposal to take action. At least 36 percent of the companies in the S&P 500 and 31 percent of the companies in the Fortune 500 now have some form of majority voting.\textsuperscript{13} In late September 2006 alone, General Motors, Wal-Mart and Exxon Mobil, the top three companies in the Fortune 500, all adopted majority vote provisions.\textsuperscript{14}

Boards of companies that have not addressed the majority vote issue may wish to consider doing so before receipt of a shareholder proposal. Recent changes to Delaware law facilitate majority voting in director elections by providing that a director can submit an irrevocable resignation that can be made effective upon the occurrence of a specified event (such as the failure to receive a specified vote for reelection). Consequently, a bylaw provision specifying a majority vote, coupled with a director resignation policy for holdover directors who do not receive the requisite vote (dubbed the “Intel model” after the first major company that adopted it), should satisfy most majority vote advocates.

The issue of majority voting may also need to be revisited at companies whose boards have adopted a “Pfizer” style resignation policy, which maintains plurality voting but requires directors who receive more “withhold” votes than “for” votes to tender their resignations. During 2006 shareholders of at least seven companies with Pfizer-style resignation policies approved shareholder proposals for majority voting bylaws. The United Brotherhood of Carpenters and Joiners of America, which has been one of the most vocal advocates of majority voting, has submitted majority vote shareholder proposals at several companies with Pfizer-style director resignation policies. In addition, ISS has announced that it will recommend that shareholders vote for both precatory and binding resolutions providing for bylaw provisions requiring a majority-vote standard.

Further complicating matters is another recent amendment to Delaware law that provides that a bylaw adopted by a vote of shareholders that prescribes the vote required for election of directors may not be amended by the board. It remains to be seen whether even the Intel model, which still allows the board to amend the bylaw, will satisfy the most ardent supporters of the majority vote movement.

Any board considering a majority-vote provision should carefully weigh the consequences of such a provision, particularly in view of the NYSE’s plan to eliminate broker discretionary voting in the election of directors and the new SEC rules permitting distribution of proxy materials via the Internet. As discussed above, the elimination of broker discretionary voting will increase the likelihood of success of a “withhold” or “against” campaign, and the new e-proxy rules will increase the likelihood of contested director elections.

\textbf{6. Board Declassification.} The trend in declassification of boards is expected to continue. For the first time in at least 10 years, a majority of S&P 500 companies do not have staggered boards.\textsuperscript{15} The decline in classified boards among the S&P 500 can be attributed in large part to the flood of shareholder proposals they have received on the subject.\textsuperscript{16} From 1999 to 2006 S&P 500 companies faced 258 shareholder proposals to declassify, compared to only 48 for S&P MidCap

\textsuperscript{11} Id.
\textsuperscript{12} Id.
\textsuperscript{14} Id.
\textsuperscript{15} Posting of David Morrison, “Study Finds More Firms Declassify,” to ISS Blog, December 18, 2006. Available at \url{http://blog.issproxy.com/2006/12/study_finds_more_firms_declass.html}.
\textsuperscript{16} Id.
companies and 22 for S&P SmallCap companies.\textsuperscript{17} As of the beginning of November 2006, 63 percent of the MidCap and 59 percent of the SmallCap companies still had classified boards.\textsuperscript{18} However, as activist shareholders turn more of their attention to smaller companies, we can expect more pressure on these companies to declassify as well.\textsuperscript{19} As of January 18, 2007, ISS was tracking 39 shareholder proposals to repeal classified boards.\textsuperscript{20}

The recently released interim report of the Committee on Capital Markets (also known as the Paulson Committee) lends additional support to board declassification advocates\textsuperscript{21}. The report, which is highly critical of classified boards, recommends that a company with a classified board be required to obtain shareholder approval when adopting a poison pill, and in the absence of such approval, redeem the pill.

While there may be increasing pressures on boards to declassify, directors should carefully consider the implications of a declassified board before reaching a decision on the matter. As highlighted by the Paulson Committee, a declassified board will reduce the deterrence effect of a poison pill, as a raider will have the ability to replace a majority of the board at a single election and then redeem the pill.

7. Behind Closed Doors: Boardroom Confidentiality. With so much attention focused on the methods used by certain individuals at Hewlett-Packard to ferret out the source of boardroom leaks, it is easy to lose sight of the initial actions that prompted their response. Unauthorized disclosure of boardroom deliberations is a serious matter. A director who leaks boardroom discussions runs a serious risk of breaching fiduciary duties, as well as violating federal securities laws and company policies.

The duty of care requires a director to exercise the degree of care that an ordinarily prudent person in a like position would use in similar circumstances, and the duty of loyalty requires a director to act in good faith, in the best interests of the corporation, and without regard to other interests, duties or obligations to which the director may be subject. While a director may believe that conveying confidential corporate information to the press is in the best interests of the corporation, a court will decide with 20-20 hindsight whether the leaks were consistent with the director’s fiduciary duties.

A director who leaks material information about the company also risks violating federal securities laws if the recipient trades on the information, or in the case of a leak to the press, if the information is misleading or incomplete. In addition, most companies have formal disclosure policies which provide that only designated company spokespersons are authorized to speak on behalf of the company.

Aside from the potential legal consequences, disclosing boardroom discussions to others is simply no way to run a corporation. Directors cannot be open and honest in their discussions if they fear that their comments or positions will appear in tomorrow’s newspaper. With the increasing success of hedge funds and other special-interest investors in placing directors on corporate boards, there will be less collegiality in the boardroom and therefore a greater risk of leaks. Directors who serve on a board at the behest of special-interest investors must not lose sight of the fact that they nevertheless owe their fiduciary duties to the shareholders as a whole.

\textsuperscript{17} Id.
\textsuperscript{18} Id.
\textsuperscript{19} Id.
\textsuperscript{21} Posting of David Morrison, supra, note 15.
EXECUTIVE COMPENSATION

8. Spotlight on Compensation Committees. New SEC disclosure rules, almost daily revelations in the stock-option backdating scandal and a spate of recent reports of hefty compensation packages for executives of poorly performing companies continue to focus attention on executive compensation and compensation committee practices. The new SEC disclosure rules require extensive discussion about how the compensation committee makes its decisions. They also place additional burdens on compensation committee members to review proxy statement disclosures and to bless the newly required Compensation Discussion and Analysis, which explains why a company has chosen to pay its executives as it does. With the additional workload, it is likely that pay for compensation committee chairs and members will approach levels paid for service on audit committees.

The use of compensation consultants by compensation committees is drawing increasing fire. Some critics argue that compensation committees simply rubber stamp the consultants’ recommendations. Another bone of contention is the use of pay consultants who also perform work for company management. In October 2006 a coalition of pension funds representing almost $850 billion in assets sent letters to the compensation committee chairs of the 25 largest U.S. companies requesting disclosure of whether compensation consultants hired by the compensation committee also perform work for company management and asking whether the company was willing to adopt a formal policy to assure the independence of compensation consultants. As of January 2, 2007, 18 companies had responded to the letter, and 10 of those companies had “best practices” policies regarding compensation consultant independence.

Compensation committees and boards that do not adhere to good compensation practices will increasingly find themselves subject to shareholder “withhold” vote campaigns. This will be particularly true in 2008 after investors have the opportunity to review the new disclosures in this year’s proxy statements. In 2006 ISS adopted a formal policy to recommend withholding votes from compensation committee members if a company has what ISS considers to be poor compensation practices. For 2007 ISS is extending its withhold recommendations to include the CEO where it determines it is appropriate and the entire board if the whole board was involved in and contributed to egregious compensation problems.22 ISS has also identified what it considers to be “poor,” as well as “best,” executive pay practices that compensation committees may wish to consider when crafting compensation.23

Additional pressure will be placed on compensation committees by shareholder proposals calling for nonbinding shareholder votes on executive compensation. This proposal typically asks that shareholders be given the opportunity at each annual meeting to ratify the compensation of the named executive officers set forth in the summary compensation table and related narrative disclosure (excluding Compensation Discussion and Analysis). As of January 18, 2007, ISS was tracking 38 “say on pay” proposals.24 In addition, the Chairman of the House Financial Services Committee plans to introduce legislation this spring that would give shareholders a vote on executive pay packages.

9. Pay for Performance. Pay for performance receives a lot of lip service, but this year, with the new SEC disclosure rules, shareholders will be able to determine whether companies who claim that they adhere to the principle actually do so in practice. Attention will be particularly focused on payments of large bonuses and equity awards that are not tied to performance measures, and to excessive “fringe” elements of compensation, such as perquisites, change in control and severance payments, and pension and retirement plans. Few topics stir the ire of investors more than reading about company-provided apartments, financial services, personal use of corporate aircraft and other perks provided to

23 Id.
executives who already have what many perceive to be generous pay packages. With respect to retirement plans, Congress may take action to cut back on excessive deferrals of compensation. On January 17, 2007, the Senate Finance Committee unanimously approved a cap on deferred compensation at the lesser of $1 million or average salary. Democrats in Congress have also announced that they will hold hearings this spring on executive pay practices, and even President Bush recently called on boards to more closely tie executive pay to performance.

Activist shareholders are not waiting until the 2007 proxy statements are out to target companies that they believe have poor pay for performance practices. So far, the most prevalent compensation-related proposal for 2007 (and second only to majority voting in terms of number of proposals filed) has been a proposal calling for compensation committees to establish a “pay for superior performance” standard with respect to executive compensation. Under the proposal, annual bonuses would not be paid unless a company’s performance exceeds the median or mean performance of a disclosed peer group of companies with respect to specified financial performance criteria, and stock-based and non-equity compensation would not be paid unless the company’s performance exceeds the peers’ median or mean performance on selected financial and stock price performance criteria. So far, 44 pay for superior performance proposals or similar type proposals have been filed.

SARBANES-OXLEY

10. Relief on the Way? 2007 marks the fifth anniversary of the Sarbanes-Oxley Act. Although most would agree that Sarbanes-Oxley has strengthened the financial reporting and governance processes for public companies, these improvements have not come without significant burdens and costs being inflicted on companies. These burdens and costs are addressed daily in the news through stories on the increasing number of public companies going private; more and more companies speaking out on the time, money and energy spent to comply with Sarbanes-Oxley; and reports and studies that reflect how Sarbanes-Oxley is negatively affecting the capital markets in the United States.

In November 2006 the Paulson Committee issued an interim report that addresses a wide range of issues relating to maintaining and improving the competitiveness of U.S. capital markets. The report concludes that U.S. regulatory compliance costs (and in particular, Section 404 of Sarbanes-Oxley, which is discussed below) and litigation risks are rendering the U.S. capital markets less competitive. The Paulson Committee makes recommendations to restore America’s competitive edge, including expansion of shareholder rights, better implementation of Section 404, a more principles-based regulatory process and securities litigation reform. Although the Paulson Committee did not call for specific statutory reforms to Sarbanes-Oxley, the report and its recommendations may put additional pressure on Congress and regulators to address ways to reduce the unintended costs of the act while maintaining certain benefits attributed to the act, such as stronger internal controls and accountability.

In addition to the report by the Paulson Committee, in January 2007 New York Sen. Charles Schumer and New York City Mayor Michael Bloomberg released a report, known as the Bloomberg/Schumer report, revealing that New York City could lose its status as the leading global financial center if there is not a major shift in regulations and public policy. Among other things, the report criticizes the complexity of Sarbanes-Oxley and calls on the SEC to take steps that the report concludes are critical for the United States to sustain its market dominance, including clearer guidance on the implementation of Sarbanes-Oxley and securities litigation reform. Even New York Gov. Eliot Spitzer, who often

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26 Id.
drew fire for his zealous investigations of financial services firms as New York attorney general, has publicly supported the report.

While it remains to be seen whether and to what extent the sweeping recommendations contained in these reports are put into action, at least some relief from Sarbanes-Oxley is at hand in two areas, namely Section 404 and government investigations of companies.

**Section 404.** Section 404, which requires that public companies annually assess, and their auditors attest to, the effectiveness of internal controls over financial reporting, has received most of the attention and blame for the burdens and costs associated with Sarbanes-Oxley compliance. The Paulson Committee report included a cost survey which showed that for 2004, the first year of Section 404 compliance, the average cost of Section 404 compliance per company was $4.36 million. This amount greatly exceeded the SEC’s original estimate of costs of $91,000 per issuer, which raises the question of whether the benefits of Section 404 exceed the costs. Much of the issue with Section 404 relates to the PCAOB’s Auditing Standard No. 2 (AS 2), which is the standard that applies to both the auditor attestation and internal management reviews to which the auditors must attest. The primary flaws of AS 2 relate to the extremely low thresholds established for determining whether there is a “material weakness” or “significant deficiency” in a company’s internal controls. These low thresholds have caused auditors to often go overboard in finding weaknesses and deficiencies in a company’s internal controls.

Both the SEC and PCAOB have recognized the severity of the problems surrounding Section 404 and are working toward changing how Section 404 is implemented. In late 2006 the SEC proposed additional guidance for management’s assessment of internal controls and the PCAOB proposed a new standard on auditing internal control over financial reporting that would supersede AS 2. The proposal is designed to focus the auditor on the most important matters and eliminate audit requirements that are unnecessary to achieve the intended benefits, as well as provide direction on how to scale the audit for smaller, less-complex companies. In addition, the SEC’s chief accountant recently indicated that the deadline for smaller companies to comply with 404 could be delayed to 2009.

**Government Investigations.** In the wake of the Enron debacle and the adoption of Sarbanes-Oxley, the Justice Department in 2003 issued guidelines, known as the Thompson Memorandum, for federal prosecutors to consider in deciding whether to bring criminal charges against a company. In particular, the Thompson Memorandum allowed prosecutors to request a waiver of the attorney-client and work-product protections and instructed prosecutors to consider a company’s willingness to comply with such waiver as a factor in evaluating the company’s cooperation. The Thompson Memorandum also allowed prosecutors to consider as a factor whether a company advanced attorneys’ fees to culpable employees and agents. These practices have drawn criticism from many quarters, including the Paulson Committee and Judge Kaplan of the Southern District of New York in a recent case involving KPMG. In addition, in December Sen. Arlen Spector introduced legislation in Congress to ban these practices.

In response to the mounting criticism, the Justice Department in December 2006 released revised guidelines, known as the McNulty Memorandum. The McNulty Memorandum provides:

- that prosecutors must demonstrate a legitimate need for the privileged information before requesting a company to waive its privilege.

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27 FEI Survey on Sarbanes-Oxley Section 404 Implementation, Financial Executives International (March 2006).
28 SEC Release No. 33-8238, June 3, 2003. This estimate only covered Section 404(a) compliance and does not reflect the Section 404(b) auditor attestation report.
• that prosecutors are not allowed to consider as factors in charging a company with a criminal offense (1) that a company declined to provide a waiver to the attorney-client or work-product protections and (2) that a company advanced attorneys’ fees to employees, provided there is a contractual obligation for such advance between the company and the employee.

In view of the McNulty Memorandum, companies should review the indemnification provisions in their charters and bylaws and consider including indemnification provisions in employment agreements that create a contractual obligation to advance attorneys’ fees to officers and appropriate employees for corporate criminal investigations.

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