

Corporate Alert

Top 10 Topics for Directors in 2013

December 3, 2012

A fog of uncertainty hangs over U.S. public companies as 2013 approaches. The looming fiscal cliff, increased regulatory burdens, the ongoing European debt crisis, growing Middle East unrest and slowing global growth are just a few of the uncertainties companies will have to navigate as they chart a course for the coming year. Here is our list of hot topics for the boardroom in 2013:

1. Oversee strategic planning amid fiscal and economic uncertainty as America approaches the fiscal cliff
2. Assess the impact of mobile technology and social media on the company's business plans
3. Address cybersecurity
4. Oversee the management of reputational risk
5. Set appropriate executive compensation as shareholders increasingly voice dissatisfaction with pay practices
6. Assess the impact of health care reform on the company's benefit plans and cost structure
7. Ensure appropriate board composition in light of changing marketplace dynamics and increasing calls for diversity
8. Monitor the company's need for, and ability to retain, key talent
9. Prepare for more government regulation
10. Manage information overload

1. Strategic Planning Amid Fiscal and Economic Uncertainty

Now that the elections are finally over, all eyes are focused on whether Congress will drive the American economy over the fiscal cliff. Uncertainty over how Washington deals with the series of tax increases and spending cuts scheduled to hit early next year is wreaking havoc on corporate budgets and business planning for 2013. Unless Congress acts, Bush-era tax cuts and other tax breaks will expire at year end, just as cuts to defense and other government programs agreed upon during the 2011 debt-ceiling compromise kick in. The Congressional Budget Office predicts that the combination of spending cuts and tax increases will throw the U.S. into a recession, shrink real GDP by 0.5 percent in 2013 and shoot the unemployment rate up to 9.1 percent.¹ Although the CBO projects that economic growth will pick up in 2014, other studies warn of much more dire consequences.²



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Concern that Congress will not avert the fiscal cliff is already slowing the economy. In October, the National Association of Manufacturers reported that one-third of manufacturing companies surveyed have deferred hiring and 17 percent have cut or delayed capital investments due to uncertainty over the country's fiscal future.³ The report estimates that fear of the fiscal cliff has already shaved 0.6 percent off economic growth for 2012. The Business Roundtable reports that CEO confidence in the economy has slipped to its lowest level since 2009.⁴ Business leaders are so concerned about the fiscal cliff that 80 CEOs of major corporations joined forces last month to press Congress to take action.

One likely scenario is that the lame-duck Congress will simply kick the can down the road by temporarily extending the tax cuts and delaying the spending cuts until sometime in 2013 when Congress can tackle these issues as part of a more comprehensive overhaul of the tax code and government spending and entitlement programs. Any resolution will likely be tied to raising the federal debt ceiling. The U.S. Treasury is already bumping up against the \$16.4 trillion statutory limit on the amount of money it can borrow, but it can tap emergency measures to continue borrowing into the first quarter of 2013.

To ensure that they have sufficient funds to weather another recession, companies have been stockpiling cash and taking advantage of record low yields to refinance existing debt and take on additional debt. In the third quarter, interest rates on triple C rated bonds reached their lowest levels on record and leverage multiples were at their highest levels since 2007.⁵ Nonfinancial U.S. companies are now sitting on \$1.7 trillion in cash and other liquid assets.⁶ Ultimately, companies will need to make important strategic decisions about whether and when to deploy these funds.

U.S. fiscal uncertainty, of course, is not the only wild card in the deck for 2013. The ongoing European debt crisis, slowing growth in China and other emerging markets, turmoil in the Middle East and budget problems in Japan will also affect how companies play their hands this coming year. Indeed, the International Monetary Fund recently warned that "the risks for a serious global slowdown are alarmingly high."⁷

In addition, as companies expand their global footprint, they face increasing competition from state-owned enterprises and sovereign wealth funds. These entities, which have more assets under management than hedge funds and private equity funds combined, are often driven by geopolitical or national strategic objectives that can skew the traditional rules of competition. Companies also must carefully assess the impact on their competitive position of government investment policies and incentives for both domestic and outbound investment activity.

One of the most important functions of the board of directors is oversight of the development and implementation of corporate strategy. 2013 will prove to be a particularly challenging year for this task as companies wait to see if and how the fiscal cliff and these other uncertainties are resolved.

2. The Age of Twitter

Mobile technologies and social media are sweeping the globe:

- By the end of 2012, the number of mobile devices connected to the Internet will exceed the world's population.⁸
- More than 1.5 billion people actively use social networks.⁹
- Every minute of the day:
 - 277,000 tweets are sent.
 - 1,736,000 pieces of content are shared on Facebook.
 - 72 hours of video are uploaded to YouTube.
 - 2.3 million search queries are made on Google.¹⁰

This ubiquitous connectivity has profound implications for businesses. A recent report by McKinsey estimates that the value created by new social technologies is potentially "transformative" and could exceed \$1 trillion annually.¹¹ Yet,

McKinsey reports, only three percent of companies are currently deriving substantial benefit from these developments across all stakeholders, including customers, employees and business partners.¹²

These new technologies fundamentally change the rules of engagement with customers. No longer are customers just passive recipients of corporate marketing campaigns. Now, customers actively participate with their friends and others in online conversations about their “likes” and experiences. With this shift in power to the customer, companies are now expected to engage in meaningful, ongoing dialogues with customers and become part of the online community. Companies that choose to ignore these developments do so at their peril. Research shows that the experiences of others has the greatest impact on a buying decision,¹³ and 50 percent of social network users post reviews of products, brands or companies on these sites.¹⁴ Moreover, this shift in customer relations applies not just to consumer products companies. B-to-b companies are significantly expanding their social media presence, particularly via LinkedIn, Facebook, Twitter, YouTube and blogs.¹⁵

In addition to these key changes in customer relationships, companies need to evaluate how mobile technologies and social media are affecting their workforce. By 2016, mobile broadband users are expected to surpass PC users in the workplace.¹⁶ With a more mobile workforce, companies can enjoy greater productivity as employees reduce commuting time, spend more time with customers and have access to the corporate network 24/7.¹⁷ Information workers already use two to three devices for work purposes,¹⁸ and by 2020, it is estimated that 83 percent of companies will have BYOD (bring your own device) policies, allowing employees to choose and purchase the mobile devices they use to connect to the corporate network.¹⁹ While this ability to connect seamlessly from multiple devices has clear advantages, it also poses important data security challenges that companies need to address.

Companies also need to decide whether to allow employees access to social media in the workplace. While it might seem obvious to companies to block workplace access to these sites to prevent employees from wasting time, at least 60 percent of employees simply circumvent their employers’ policies by using personal devices.²⁰ Another area of concern is the extent to which employees may actively participate in social media platforms. Training programs should be provided for those employees who are encouraged to participate so that the company can send a strong, consistent message. At the same time, corporate communications policies that restrict the posting of negative comments by employees about their employer must be carefully crafted to ensure that the policies do not chill employee rights under the National Labor Relations Act. The NLRB recently ruled that Costco’s policy was overly broad and ran afoul of the statute.

In addition to changes in the workforce, the rapid growth of mobile technology is also allowing companies to cut costs by downsizing their office space. Businesses expect to reduce their office space by 17 percent by 2020, as “hotdesking” (having fewer desks than employees) becomes the norm.²¹

As part of its oversight duties, the board of directors needs to ensure that management is appropriately addressing the strategic opportunities and challenges posed by the explosive growth of digital mobility and social media. Directors need to understand how these forces are shaping the competitive landscape, affecting customer relationships and impacting the company’s workforce. They need to probe management’s knowledge, plans and budget decisions regarding these developments. And they need to understand and weigh the risks created by the use of mobile technologies and social media by company personnel and ensure that appropriate policies are in place.

This oversight responsibility may be particularly challenging for the average director of a public company, who, at 60-plus years of age, may not have embraced these developments to the same degree as his or her children. In one recent survey, over half of the directors surveyed said that they were not adequately engaged with new business models that are enabled by advances in information technology, and more than two-thirds were not aware of how their company monitors social media for adverse publicity.²²

3. Cybersecurity

In a recent study, directors identified data security as their number one concern.²³ High-profile cyber breaches this past summer at LinkedIn and Yahoo, as well as national debate over the vulnerability of the nation's infrastructure to a catastrophic cyber attack, have placed cybersecurity on the radar screen of virtually all companies. With the growing use of cloud computing and mobile devices, corporate data will become even more vulnerable to attack.

In recognition of the dramatic rise in cyber attacks and data breaches, the SEC issued guidance in October 2011 regarding company disclosure obligations about cybersecurity risks and cyber incidents. Since then, the SEC has continued to push for more disclosure. Amazon received an SEC comment regarding a cyber attack that occurred in January 2012 at its Zappos.com subsidiary that resulted in the theft of personal identity information from 24 million customers. In response, Amazon finally disclosed in its July 2012 quarterly report that some of its subsidiaries had past security breaches, even though Amazon did not believe the incidents had a material adverse effect on Amazon's operating results. Similar SEC comment letters have been issued to at least 25 other companies.

Companies understandably are reluctant to highlight cyber breaches, fearing damage to reputation, lost customers and litigation. Amazon was hit with nine class action lawsuits stemming from the Zappos incident.²⁴ In addition to suits brought by victims and shareholders, companies can also face increased regulatory scrutiny. After Wyndham Worldwide Corporation suffered three major attacks in just two years, the FTC sued the company in June 2012, alleging unfair and deceptive trade practices relating to statements in the company's privacy policy about the importance the company placed on protecting customer information.

During 2012, Congress debated several bills aimed at improving cybersecurity at companies critical to the nation's infrastructure. After these efforts stalled in Congress, Senator John D. Rockefeller IV, Chairman of the Senate Commerce Committee, sent letters in September 2012 to the CEOs of all Fortune 500 companies inquiring about their company's cybersecurity practices. President Obama reportedly is considering a potential executive order on cybersecurity to foster collaboration with the private sector in securing the nation's critical infrastructure.

As part of a board's risk management oversight function, directors should carefully assess the adequacy of their company's data security measures.²⁵ They should also inquire about their company's contingency plans for responding to a cyber attack. Another area of concern is the adequacy of the company's insurance coverage for data breaches. Some insurance companies have sought to deny coverage for cyber losses under traditional general liability policies. Consequently, many companies are purchasing separate cyber risk insurance.

4. Protecting the Company's Most Valuable Asset: Its Reputation

Warren Buffet once said, "It takes 20 years to build a reputation and five minutes to ruin it." In the age of Twitter, those five minutes can now be as short as five seconds.

The importance of reputation cannot be overstated. JPMorgan, for example, lost \$27 billion in market value in the month after weaknesses in its risk management practices were exposed, even though its actual trading losses were estimated at the time to be less than \$6 billion. Highly regarded companies enjoy higher market values, lower costs of capital and greater customer loyalty.²⁶ They also attract the best talent and are more likely to be given the benefit of the doubt when a miscue occurs.²⁷ It is estimated that reputation accounts for over 60 percent of the average S&P 500 company's value.²⁸

Not surprisingly, reputational risk was top of mind in a recent poll of directors regarding nonfinancial risks.²⁹ As part of its responsibility for overseeing risk management, the board plays a vital role in protecting a company's reputation. Getting a handle on this risk, however, is not an easy task. For one thing, it is an amorphous concept. Corporate reputation is generally understood as the way the company is seen by its various stakeholders, including customers, suppliers, shareholders, employees, regulators and communities. Because these different stakeholders view the company differently, corporate reputation is a relative and fluid concept.³⁰ Adding to the challenge is the fact that there

are differing schools of thought on whether reputational risk is a risk category in its own right, or merely a consequence of a failure to manage other risks effectively.³¹ In most instances, reputational damage is triggered by some other business risk to the company, most often an operational risk that relates 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.³² But a lapse in managing one of these first-tier risks does not tell the whole story: a company can do everything right and still take a hit to its reputation from unfounded rumors or other totally exogenous sources.

Because reputation is such a vital asset and it is so intertwined with other risks a company faces, it is important that it be managed through an enterprise-wide, holistic approach to risk management. Within an ERM framework, the board of directors needs to ensure that management has properly prioritized the various stakeholder groups based on the extent to which they are instrumental to the company's pursuit of its long-term objectives and that the company's risk inventory appropriately takes reputation into account.³³ In addition to the traditional "inside-out" approach of ERM, however, it is also important for companies to include an "outside-in" component to their management of reputational risk. That is, in addition to focusing on what the company can see and foresee, firms need to continuously monitor the external environment, listen to key stakeholders and track their sentiments and views.³⁴

Some key areas of focus for directors overseeing the management of reputational risk include:

- *Social media.* In the digital age, where one disparaging tweet can easily go viral and tarnish a company's reputation that has taken decades to build, companies must be more vigilant than ever in guarding their reputations. According to one recent study, however, only a fifth of the companies surveyed continuously monitor reputational risk.³⁵
- *Data breaches.* A recent Ponemon survey found that the value of brand and reputation can decline 17 to 31 percent of annual gross revenues after a data breach and that it can take an organization a year to recover its corporate image.³⁶
- *Response planning.* The board needs to make sure that the company has an effective and up-to-date crisis response plan in place. While many companies think it can never happen to them, research shows that a large public company faces an 80 percent likelihood of experiencing a corporate crisis during any 5-year period that results in a loss of market value of at least 20 percent.³⁷ Research also shows the importance of having an effective communications strategy in place. For example, companies faced with ethical violations that disclose promptly, take responsibility and demonstrate credible follow-up behaviors recover more quickly compared to companies that issue delayed, opaque or partial responses and fail to take responsibility or express contrition.³⁸

5. Executive Compensation

Executive compensation continues to be a hot topic. According to a recent survey, 72 percent of respondents ranked executive compensation as the number one topic for boards of directors in the past 12 months.³⁹ In addition, investor and issuer respondents to ISS's 2012-2013 policy survey cited executive compensation as the most important topic for their organization for the coming year.⁴⁰ We highlight below some of the matters directors should be considering as they craft executive compensation for 2013:

- *Impact of Prior Say-on-Pay Vote.* For the vast majority of companies, 2012 was the second year for shareholders to vote on executive compensation practices. As in 2011, shareholders seemed quite content, with 91 percent of companies receiving over 70 percent shareholder approval of say-on-pay proposals and fewer than 3 percent of companies experiencing a failed say-on-pay vote in 2012.⁴¹ Certainly, companies that failed to win shareholder support should seriously consider whether changes to their pay practices should be made. But even companies that received strong shareholder support need to be attentive to shareholder concerns. Over 60 companies saw their say-on-pay approval levels plummet from above 90 percent in 2011 to below 70 percent in 2012.⁴² SEC rules now require companies to disclose in their proxy statements whether – and if so, how – they considered the results of the say-on-pay vote in determining executive compensation policies and decisions. According to a recent survey,

64 percent of companies responded to the prior year's say-on-pay vote by taking some sort of action, including enhancing their proxy statement compensation disclosures, making compensation more performance-based, and increasing communications with proxy advisory firms.⁴³

- *Proxy Advisory Firm Recommendations.* ISS continues to flex its muscle. Shareholder support for say-on-pay averaged 30 percent lower at companies that received a negative vote recommendation from ISS in 2012.⁴⁴ Because proxy advisory firm recommendations can be a key driver to the outcome of a say-on-pay vote, companies need to analyze their shareholder base to determine the level of influence proxy advisors have on their investors. Also, an increasing number of companies that receive a negative recommendation from a proxy advisory firm are refuting the recommendation through supplemental proxy filings and shareholder outreach. Filing supplemental materials gives companies an avenue to address inaccuracies in the proxy advisory firm recommendation and to further strengthen their case. However, because supplemental filings cost money and may draw unwanted attention, many companies opt for direct engagement with major shareholders, as discussed below.

Companies also need to stay abreast of any changes in the voting recommendation policies of proxy advisory firms. Because of criticism over ISS's peer group selection process, ISS has updated its proxy voting policies for 2013 to take into account a company's self-selected benchmarking peer group, in addition to the company's industry group, size and market capitalization, which had been ISS's previous focus.⁴⁵ ISS's 2013 policy updates also make clear that hedging of company stock or significant pledging of company stock by executive officers and directors will be considered a risk oversight failure that will trigger a negative voting recommendation for some or all directors.⁴⁶ ISS reasoned that hedging transactions sever the alignment with shareholders' interests and therefore, any hedging will be considered a problematic practice warranting a negative vote recommendation. ISS also believes that pledging of company stock is not a responsible use of equity because of the detrimental impact it could have on shareholders if the director or officer is forced to sell. For those companies that have executive officers or directors who have pledged company stock, ISS will consider various factors in determining its vote recommendations for the election of directors.⁴⁷ In light of ISS's position on hedging and pledging and a pending Dodd-Frank rule that would require companies to disclose whether they allow hedging by employees and directors, companies should carefully review and, if appropriate, revise their policies with respect to these matters.

- *Shareholder Outreach.* Shareholder outreach is an effective way for companies to learn about, and address, shareholder issues and concerns, strengthen the company's relationship with its shareholders and lessen proxy advisory firm influence on investors. According to a recent survey, 27 percent of boards stepped up their communications with institutional investors in the past year.⁴⁸ According to the same survey, 62 percent of boards speak with institutional investors, while one-third say the board should not have such direct communication.⁴⁹ Companies that allow directors to communicate directly with shareholders should take certain steps to address Regulation FD concerns, such as pre-clearing discussion topics with the shareholder, having company counsel attend the meeting or obtaining a confidentiality agreement from the shareholder.⁵⁰
- *Peer Group Benchmarking.* In setting the pay of CEOs and other executive officers, boards of directors commonly use a company's peer group to benchmark how much executives at other companies are making, and then, to be competitive with the peer group, target their compensation levels at the 50th, 75th or 90th percentile of the peer group. Although this methodology is commonly used, and believed necessary by many for executive retention, peer group benchmarking has come under criticism. A recent study reveals some flaws in this methodology and shows that CEO skills are not readily transferable, that CEO moves do not happen all that often and that benchmarking executive pay at median or higher levels has contributed to the dramatic rise in executive compensation over the years.⁵¹ In light of this study, some commentators have speculated that overreliance on peer group benchmarking may be a new avenue of attack by the plaintiffs' bar. Peer group benchmarking can give boards some helpful comparative information when the peer groups are honestly constructed, but benchmarking should just be one of many factors that the board considers when setting executive pay.
- *Compensation Committee and Advisor Independence.* The SEC recently adopted rules requiring the national securities exchanges to adopt new listing standards relating to compensation committees and their selection of compensation consultants, legal counsel and other advisors. The new rules require the exchanges to address

compensation committee member independence, a compensation committee's authority to retain, and its responsibility regarding, compensation advisors, and a compensation committee's analysis of the independence of its advisors. Exchanges have submitted to the SEC proposed amendments to their listing standards, which need to be finalized and approved by the SEC no later than June 27, 2013. The SEC also adopted a new proxy statement disclosure requirement, which will be in effect for the 2013 proxy season, that requires companies to disclose, with regard to a compensation consultant whose work has raised any conflict of interest, the nature of the conflict and how the conflict is being addressed.⁵² At this point, companies need to begin preparing for the compensation consultant conflict of interest disclosure by determining whether any conflicts exist and what will need to be disclosed in the 2013 proxy statement. Although the other provisions of the rules will not kick in until later in 2013, companies should also begin making independence assessments of their compensation advisors and analyzing the independence of their compensation committees so they are ready once the new rules become effective.

- *Pending Dodd-Frank Regulations.* Much to the delight of companies, the SEC is behind in its rulemaking on several provisions required by the Dodd-Frank Act. Nevertheless, companies should begin planning how they will implement and comply with the new rules once adopted.
 - *Pay for performance and pay disparity disclosures.* One of the Dodd-Frank Act's more contentious provisions calls for companies to disclose in their annual proxy statements the relationship between executive compensation and the company's financial performance, as well as the ratio of the CEO's annual total compensation to the median annual total compensation of all other employees. Companies would be wise to begin laying the groundwork in their 2013 proxy statements by showing a strong link between pay practices and performance. Companies should also begin thinking about how to explain the pay disparity between the CEO and employees. According to a recent study, corporate CEOs are now making 380 times the salary of the average American worker, up from 42 times in 1980.⁵³
 - *Clawbacks.* The Dodd-Frank Act also calls for the SEC and stock exchanges to implement rules requiring companies to develop and disclose clawback policies for the recovery of incentive-based compensation granted to any current or former executive officer during the three-year period preceding an accounting restatement that is based on erroneous data corrected in the restatement. The language in the statute is broader than the clawback provisions in the Sarbanes-Oxley Act, which apply only to the CEO and CFO, have only a one-year look-back and require misconduct.
- *Lawsuits on Executive and Director Compensation.* Following failed say-on-pay votes in 2011, shareholders at some companies filed suits claiming that directors had breached their fiduciary duties when making executive compensation decisions. For the most part, courts have dismissed these suits, holding that a failed shareholder say-on-pay vote does not rebut the business judgment rule presumption attached to a board's decision on executive compensation. Recently, the plaintiffs' bar has turned to a new tactic, filing class action lawsuits *before* shareholder meetings seeking to enjoin either a shareholder say-on-pay vote or a vote to amend an equity compensation plan on the grounds that the proxy disclosures are misleading and incomplete. In several instances, plaintiffs have successfully pressured companies to provide additional disclosure, obtained injunctions or obtained attorney's fees. Because this trend is likely to continue in 2013, companies should pay particular attention to the adequacy of their 2013 proxy disclosures.

Directors should also take extra care when determining their own compensation. The Delaware Chancery Court recently declined to dismiss a claim against a company's directors that they breached their fiduciary duties by awarding themselves equity grants that the plaintiffs claimed were excessive and amounted to corporate waste.⁵⁴ The defendants had argued that awards were made under an equity plan that had been approved by stockholders and that the board's decision should be given the deference of the business judgment rule. The plan, however, gave the board broad discretion to determine the amounts and terms of the awards, subject to certain typical limits on the number of shares available under the plan and an annual cap on awards to individuals. The court ruled that 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, and 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.

6. Health Care Reform

With President Obama's re-election and a recent U.S. Supreme Court decision largely upholding the constitutionality of the Patient Protection and Affordable Care Act of 2010, the fate of health care reform no longer appears to be in doubt. While it is possible that the implementation of certain features of health care reform may be delayed as part of a compromise by Congress to avert the fiscal cliff, companies should nevertheless begin preparing for certain key provisions of the statute that are currently scheduled to take effect starting in 2014. Because these provisions will have a major impact on most companies, boards of directors need to be planning how their companies will comply with these regulations and the effect such compliance will have on their company's cost structure and strategy going forward.

Set forth below is a brief summary of certain key provisions of health care reform that are looming, followed by actions for boards to consider.

State Insurance Exchanges. By January 1, 2014, each state is required to establish a health insurance exchange that, among other things, will facilitate the purchase of and make available "qualified health plans" to qualified individuals and employers. For those states that are not able to, or that have opted not to, establish an exchange, the U.S. Department of Health and Human Services will establish and operate a "federally facilitated exchange" for such state. Employees of companies with fewer than 50 full-time employees will generally be eligible to purchase insurance within the state insurance exchange (or federally facilitated exchange) and possibly receive a federal subsidy without any penalty to the company. But, as discussed below, larger companies with employees who purchase insurance through these exchanges will be required to pay a penalty.

Play-or-Pay. Employers are not required under health care reform to provide health insurance to employees. But beginning January 1, 2014, employers with 50 or more full-time employees, referred to as "large employers," will have to pay a penalty if (i) they do not offer health insurance to employees or (ii) they offer health insurance to employees, but the insurance does not meet certain affordability or benefit requirements. If a large employer does not offer health insurance, and one or more of its employees enrolls in a state insurance exchange and receives a federal government subsidy, the employer will be required to pay a fee of \$166.67 per month (\$2,000 annually) for each full-time employee, excluding the first 30 full-time employees. If a large employer does offer health insurance, but one or more of its employees nevertheless enrolls in a state insurance exchange and qualifies for a federal government subsidy, the employer will be required to pay the lesser of (i) \$166.67 per month (\$2,000 annually) for each full-time employee, excluding the first 30 full-time employees, and (ii) \$250 per month (\$3,000 annually) for each full-time employee who receives the subsidy.

Excise Tax on High-Cost "Cadillac" Plans. Beginning January 1, 2018, certain high-cost group health plans, both insured and self-insured, will be subject to an excise tax of 40 percent on the amount by which the health plan's annual cost for coverage, including both employer and employee contributions, exceeds \$10,200 for single-only coverage and \$27,500 for family coverage.

In light of these provisions, there are several actions boards should be taking to prepare their companies for what is to come. These actions include the following—

- *Assess strategy and costs relating to play-or-pay.* Most companies that currently offer health benefits to employees are expected to continue to do so for the foreseeable future. Because health benefits are often viewed as an important part of an employee's compensation package, eliminating health care coverage for employees and paying the penalty may not be a viable option for some companies. But it will be important for the board of directors to know the company's options and responsibilities under the statute to best determine whether the company should take the "play" or "pay" approach in 2014. In making this determination, the board should consider, among other

things, (i) the costs of the company's health care programs and what steps the company can take to manage these costs, (ii) the amount of any penalties the company would have to pay under the statute if it eliminated health care coverage for its employees and (iii) the actions taken with respect to health care by other companies in the industry. If the company does elect to "pay" instead of "play," it will need to carefully consider how to explain its decision to employees and inform them of their options.

- *Review and redesign, if necessary, current health care programs.* The cost for employer health care is high and it is expected to increase another 5.3 percent in 2013.⁵⁵ Companies should be using health care reform as a catalyst to review and redesign their health care programs as necessary to slow these rising costs. Many companies are already taking steps to manage health care costs by, among other things, increasing the share employees and their dependents pay in premium contributions, using waivers or surcharges for spouses who have other available coverage, implementing higher medical and pharmacy deductibles, eliminating retiree health benefits, encouraging enrollment in high-deductible health plans and reviewing the company's relationship with its providers. According to a recent study, 54 percent of companies that offered health care coverage in 2012 shopped for a new health plan or insurance carrier in the previous year.⁵⁶

Managing costs will become even more significant for companies as 2018 approaches and the excise tax kicks in for high-cost plans. Research shows that, based on current projections, 58 percent of companies expect to hit the excise tax threshold in 2018 and 83 percent of companies plan on making changes to their health care plans in the coming years to control their costs and avoid the excise tax.⁵⁷

- *Stay abreast of developments.* Because of the statute's sheer volume and complexity, education is key to ensuring that directors understand the statute's relevant provisions, their effective date(s) and the implications they will have on the company. Boards also need to be fully informed of any evolving guidance and interpretive regulations relating to the implementation of the law so they can effectively formulate a strategy for dealing with it going forward. Federal agencies have already begun issuing guidance addressing certain aspects of the legislation, and much more is expected leading up to 2014.
- *Encourage a healthy workforce.* Having a healthy workforce can give a company a competitive advantage. Companies should consider increasing their commitment to improving the health of their workforce by focusing on wellness initiatives and adopting or expanding the use of financial incentives to encourage healthy behaviors.

7. Board Composition

With increasing globalization and changing marketplace dynamics, it is essential that boards of directors have the right mix of experiences and competencies to oversee the new opportunities and risks their companies face. While industry experience and financial expertise remain the most sought after skills in director candidates,⁵⁸ some other attributes that boards should consider include:

- *IT/Digital expertise.* In one recent study, over 99 percent of the directors surveyed believed that information technology would have a significant impact on their company in the next five years, yet almost half (47 percent) were dissatisfied with their board's ability to oversee IT risks.⁵⁹ Insufficient expertise at the board level was the most often cited stumbling block to effective oversight.⁶⁰ As mobile technologies and social media play an expanding role in business, boards of almost all companies would benefit from the addition of a digital-savvy director. To fill this void, boards may have to step out of the box of traditional director traits and tap candidates who are younger and have less conventional backgrounds.
- *International experience.* About 40 percent of the profit of S&P 500 firms now comes from overseas. Companies seeking to enter international markets or further expand their global reach may well benefit from the insights of a director with international experience. According to one recent survey, U.S. directors ranked international expertise as the second most missing or underrepresented skill on their board, second only to technology expertise.⁶¹

- *Diversity.* Boards need to consider the extent to which diversity should be a factor in the optimal mix of attributes and skills needed for an effective board. “Pale, male and stale” is a phrase that is often aptly applied to the boards of directors of major corporations. Women account for just 17 percent of independent directors at S&P 500 companies, and minorities comprise only 15 percent of all directors of S&P 200 companies.⁶² Although most companies say that they are committed to diversity, minority and female representation on boards has barely budged in the last five years.⁶³ Many companies complain that a shortage of qualified candidates limits their ability to diversify. It is interesting to note, however, that at the 20 S&P 500 companies led by women, women directors comprise 29 percent of all board members.⁶⁴

Companies are facing increasing pressure to diversify their boards. The SEC requires companies to disclose in their proxy statements whether and how the board or nominating committee considers diversity in identifying director candidates. After public outcry over its all-male board, Facebook added a woman director shortly after its IPO. And in Europe, several countries, including France, Belgium and Italy, passed legislation during 2011 imposing mandatory gender quotas on public company boards, and the EU is debating a European-wide initiative to address gender imbalance in the boardroom.

Several recent studies show a positive correlation between women in the boardroom and company financial performance, particularly during times of economic stress.⁶⁵ Other recent studies show that diverse groups make better decisions than homogenous groups,⁶⁶ and that companies with women in the boardroom have stronger corporate governance practices.⁶⁷ Consumer products companies may particularly benefit from the input of women in the boardroom since it is estimated that women control about 70 percent of global consumer spending.⁶⁸

8. The Talent Challenge

Getting and keeping the right talent is becoming a major issue for companies. Even though more than 20 million Americans are looking for work or are underemployed, U.S. companies report that they cannot find qualified workers to fill three million positions. This talent shortage is only expected to grow worse. It is estimated that by 2020, the U.S. will be short 7.5 million high- and medium-skilled workers, and globally employers will face a shortage of 85 million such workers.⁶⁹

As part of its oversight responsibilities, the board needs to assess management’s plans to address current and future talent needs. Directors need to ensure that management has identified the employees and skills that are most critical to the company’s success and that management is implementing appropriate strategies to attract and retain key talent.

There are a variety of measures companies can take to address their human capital needs:

- *Going global.* Companies are increasingly seeking talent on a worldwide basis, setting up operations where the skills are located, and relying on virtual technology for jobs that can be performed remotely. According to one study, by 2021, there will be 217 million college-educated workers in emerging market countries compared to just 143 million in the developed world.⁷⁰
- *Worker retraining.* Companies are tapping into their own labor pool to identify candidates who possess key soft skills, such as problem-solving and critical thinking, and then training them for higher-skilled jobs within the organization. In addition to offering internal training programs, many major companies provide tuition assistance, flexible work schedules and bonuses for employees pursuing advanced education.
- *Education partnerships.* Companies are partnering with community colleges and other higher-education institutions to tailor training programs that meet company-specific needs.
- *Retention attention.* Companies need to pay close attention to keeping the employees that they do have. The cost of hiring and training a new employee can easily run between 30 and 250 percent of the new hire’s annual compensation.⁷¹ In addition to making sure that its compensation packages are competitive, a company needs to

ensure that it is viewed as a great place to work. The company's culture, employees' understanding of their role in fulfilling the company's mission and the opportunity for advancement are all important elements of the retention mix. Employers can also retain valued older workers and more women by offering flexible work schedules.

- *Immigration reform.* Companies can call on Congress to open the U.S. borders to highly-skilled immigrants. For example, the H1-B visa, which is the employment visa for highly-skilled workers in specialty occupations such as science, technology, engineering and math, is currently capped at 65,000 a year. The quota was reached in June of this year. Similarly, visas available to foreigners who graduate from U.S. universities with advanced degrees are capped at just 20,000 a year, forcing thousands of these highly-educated workers to leave the country.

9. More Regulation on the Way

Compliance fatigue is setting in at many companies. Constantly changing and overlapping legislative and regulatory requirements are weighing down corporations and usurping more and more board time. It is a telling sign when directors list compliance risk as one of their top risk concerns.⁷²

These concerns are well founded. According to one study, the average number of significant federal regulations — defined as those expected to have an economic impact of more than \$100 million — finalized each year has risen with every administration over the past 20 years, going from 27 per year under President Clinton, to 35 per year under President George W. Bush, to 44 per year under President Obama during his first three years in office.⁷³ Companies can expect more of the same during President Obama's second term:

- Two-thirds of the 398 total rulemakings mandated by the Dodd-Frank Act have yet to be finalized.⁷⁴
- Health care reform is just beginning, with many of the major reform measures to kick in during 2014 and much of the regulations yet to be drafted.
- Both parties have called for an overhaul of the federal tax code, which could significantly affect not only the taxes companies pay, but also the taxes paid by their customers, suppliers and investors.
- In his acceptance speech, President Obama signaled he may use his second term to fight global warming, which could spell tougher restrictions on energy companies and additional fuel-efficiency requirements for auto makers.

Fed up with new regulatory requirements, businesses have begun fighting back. Emboldened by a successful court challenge to the SEC's proxy access rule, the U.S. Chamber of Commerce, the National Association of Manufacturers and the Business Roundtable have filed suit to stop the SEC's new conflict minerals rule. This rule, which was mandated by the Dodd-Frank Act, carries an estimated total initial compliance price tag of \$3 to \$4 billion. Business groups have also mounted legal challenges to another new SEC rule mandated by the Dodd-Frank Act that requires resource extraction issuers to disclose certain payments to U.S. federal and foreign governments.

In addition to the slew of regulations in the pipeline, companies can also expect to see continued vigorous enforcement of existing regulations. During the President's first term, the SEC brought a record number of enforcement cases and the FTC and DOJ Antitrust Division successfully blocked several major proposed mergers. On the labor and employment front, the various federal agencies, including the Department of Labor, NLRB, EEOC and OSHA, are expected to continue to pursue aggressive enforcement and rulemaking agendas.

10. Information Overload

If you google "information overload," you are instantly overwhelmed with 9.4 million hits.⁷⁵ The torrent of information directed at us through e-mails, text messages, tweets, telephone calls and social media is taking a serious

toll not just on individuals but on companies as well. According to one estimate, information overload costs the U.S. economy over \$900 billion a year in reduced productivity and innovation.⁷⁶ The average white collar worker now spends 51 percent of his working day receiving and managing information, rather than actually using the information to do his job.⁷⁷ At one major company, it was estimated that 30 percent of the e-mail messages employees received were unnecessary.⁷⁸ And it is not just the time spent looking at these e-mails that is wasted: it takes the average worker 24 minutes to recover from an e-mail interruption and return to the suspended task.⁷⁹

Most of us like to think that we are good at multi-tasking, but most of the evidence suggests otherwise. In one study, participants taking an IQ test while being interrupted by e-mails and phone calls performed on average 10 points lower than a group without interruptions.⁸⁰ Other research shows that multi-taskers make more mistakes,⁸¹ are less creative,⁸² and take longer to complete tasks.⁸³

We all know how hard it is to resist the temptation to check our smartphone or e-mail when we are “pinged.” Some have speculated that our brains are wired to react to new opportunities and threats and therefore we are naturally drawn to these stimuli. Indeed, some individuals get such a rush from digital cues that their brains undergo neurobiological changes similar to those seen in drug addicts.⁸⁴

In view of the significant drag on productivity, companies need to address information overload and attention fragmentation in the workplace. Companies can help employees manage information more efficiently by encouraging them to take quiet time away from their computers and set specific times to check e-mails, teaching e-mail communication etiquette, and establishing days or times when nonessential e-mail communication is discouraged. In fact, simply telling employees that there is a problem can reduce information overload by 10 percent.⁸⁵ Companies or individuals can also install distraction blockers on their computers and take advantage of new software programs and smartphone applications that integrate and filter information across multiple e-mail and social media sites, thereby reducing the amount of time wasted searching for information.

Of course, these problems are not limited to employees only. Directors face their own challenges with information overload. In one recent survey, 56 percent of directors responding said that they had increased the amount of time they devoted to board work in the past year.⁸⁶ Demands on director time will only increase as directors struggle to keep pace with the velocity of change in an increasingly complex and interconnected world. To carry out their responsibilities effectively, directors must make sure that all board processes follow best practices, that board information packets provide only the level of detail the board desires and that board meetings are run efficiently, without interruption and with the appropriate level of attention devoted to the key issues the board needs to address.

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