AKIN GUMP
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CORPORATE ALERT

TOP 10 TOPICS FOR DIRECTORS IN 2010

Having survived the worst economic crisis since the Great Depression, most companies are breathing a sigh of relief and cautiously looking forward to a brighter future in 2010. Here is our list of hot topics that directors of public companies will be focusing on in the coming year:

1. Addressing challenges to the director election process resulting from regulatory changes and increased shareholder activism.
2. Overseeing enterprise-wide risk management, which includes all facets of a company's risk profile, including operational, financial, strategic, compliance and reputational risks.
3. Setting appropriate executive compensation in the midst of increased regulatory scrutiny and continuing public outcry over excessive pay packages.
4. Overseeing the development of longer-range corporate strategy as the day-to-day challenges of the financial crisis and recession subside.
5. Ensuring appropriate board composition and leadership structure.
6. Seizing M&A opportunities as the credit markets continue to thaw.
7. Shoring up takeover defenses where depressed share prices have made companies vulnerable to hostile bids.
8. Ensuring that an effective succession plan is in place.
9. Cultivating shareholder relations while investors push for more board transparency and accountability.
10. Monitoring legislative developments and preparing for more government regulation.

DISCUSSION

1. Director Election Process Under Siege

Directors will find it harder to get elected in 2010. The elimination of broker discretionary voting in director elections and increasing shareholder activism will pose major challenges for director elections in the coming year.

Elimination of Broker Discretionary Voting. Commencing January 1, 2010, brokers will no longer be permitted to use their discretion in voting for directors in uncontested elections where the brokers have not received specific instructions from their clients on how to vote the shares.

Because brokers typically have cast discretionary votes in favor of management's nominees in uncontested elections, the rule change is expected to have a major impact on public companies. The rule change, which amends New York Stock Exchange Rule 452, applies to all brokers that are NYSE member firms and, therefore, will affect all public companies regardless of the stock exchange on which a company's stock is listed.

Shareholder Activism. Shareholder activists will likely maintain, if not increase, their efforts to unseat directors next year. In 2009, proxy fight activity reached record heights, with 140 proxy fights commenced, compared to 125 in 2008.[1] Dissidents won at least one board seat in 25 of the 50 contests that went all the way to a shareholder vote and obtained settlements that included at least one board seat in 26 other contests.[2] Also, as discussed more fully below, "just vote no" campaigns in which shareholders are urged to withhold votes from the company's director candidates will be more popular than ever next year due to the elimination of broker discretionary voting.

Proposed Changes to SEC Proxy Rules. In October, SEC commissioners announced that they were postponing, at least until early 2010, a final vote on a controversial proposal that would give shareholders the right to have their director candidates included in company proxy statements. The proposal would allow a shareholder (or group of shareholders) who owns at least 1 percent of a public company that is a large accelerated filer (or 3 or 5 percent for smaller companies) and who has held the shares for at least one year, to use the company's proxy materials for the nomination of up to 25 percent of the company's board of directors. While postponement of the SEC's decision means that proxy access rules will not be in effect for the main part of the 2010 proxy season,[3] the SEC is nevertheless expected to adopt some form of proxy access in 2010. Consequently, most companies will need to begin addressing the rule changes by the fall of 2010 as they gear up for the 2011 proxy season. During 2009, Delaware amended its corporation law to expressly allow (but not require) companies to adopt bylaw provisions giving shareholders the right to have their nominees included in the company's proxy statement. However, almost all companies are adopting a "wait and see" approach to final SEC action before making any proxy-access related changes to their bylaws.

In addition to its proxy access proposal, the SEC is proposing a rule change that would facilitate "just vote no" campaigns by allowing activists to distribute to shareholders duplicate copies of management's proxy card without having to comply with most of the SEC's other proxy rules. If the amendment is adopted, activists will have a relatively cheap and easy way to get shareholders to change their vote without having to request another proxy card from management. In December 2009, the SEC announced that it was postponing a vote on this proposal until the SEC takes up the proxy access proposal, and, thus, it is not clear whether or when this proposed rule change would become effective.

What Boards Should be Doing Now. For the 2010 proxy season, boards of all public companies will need to understand and assess the likely effect that the elimination of broker discretionary voting will have on their companies. Among other things, boards will need to—

- *Calculate the Broker Discretionary Vote*. Boards and management of many companies are currently working with their legal advisors and proxy solicitation firms to calculate the likely effect that the loss of the broker vote will have on their particular company, based on the composition of the company's shareholder base and the turnout at prior annual meetings. A study by Broadridge on the 2009 proxy season[4] shows the significant impact that broker discretionary voting has on most companies. On average, broker discretionary votes represented almost 22 percent of the votes cast at annual meetings. At smaller companies with 1,000 to 4,999 beneficial shareholders, 48 percent of the shares voted were discretionary votes by brokers.[5] One way to estimate the potential effect of the loss of the broker discretionary vote is to look at the voting results from the most recent annual meeting at which brokers did not have discretion to vote on a matter (such as approval of an equity compensation plan) and subtract the broker non-votes from the votes cast "for" directors.

- *Consider Effect on Majority Voting.* Companies with majority voting for the election of directors will find it more difficult to achieve that threshold in 2010. A significant number of companies, including over two-thirds of S&P 500 companies and 46 percent of Russell 1000 companies, have some form of majority voting, which typically requires that a nominee receive a majority of the votes cast in order to be elected and that an incumbent director up for re-election resign or offer to resign if the director does not receive a majority of the votes cast.[6] Because brokers typically cast discretionary votes in favor of management's nominees, the elimination of broker discretionary voting will make it more difficult for a nominee to achieve a majority vote.

- *Assess Vulnerability to "Vote No" Campaign*. The elimination of broker discretionary voting will likely increase the impact and frequency of "vote no" campaigns. Regardless of whether a company has plurality or majority voting, the company can be targeted with a "just vote no" campaign in which shareholders are urged to withhold their votes from the entire board or selected nominees in an uncontested election. Without the inclusion of broker discretionary votes in favor of management nominees, "vote no" campaigns waged by activist shareholders will have a greater influence on director elections, as there will be fewer votes cast "for" the company's nominees to outweigh those votes that are "withheld" or voted "against" such nominees.

  Of course, if a company has plurality voting, directors in an uncontested election will still be elected so long as they receive *any* votes. Nevertheless, a successful "vote no" campaign that results in a high withhold vote can send a clear message of shareholder discontent to the board. For companies that have a majority voting standard, opposition votes from a majority of the shares that are voted can result in the targeted directors having to tender their resignations.

  Although we will likely see an increase in "vote no" campaigns in 2010, it should be remembered that directors at most companies receive overwhelming support each year. A study by RiskMetrics Group of voting results on over 12,000 directors at S&P 500 and Russell 3000 companies in 2009 showed that the average votes withheld or cast against board members was just 7.2 percent.[7] While that number is up from 5.1 percent in 2008 and 4.9 percent in 2007, it is clear that most directors have little to fear. The trends do, however, indicate that more and more directors will be facing opposition. During the 2009 proxy season, 93 directors at 50 companies received fewer than 50 percent of the votes cast in uncontested elections, almost three times the 32 board members at 17 companies who failed to earn majority support in 2008.[8] In addition, one out of every 10 unopposed candidates in 2009 had at least 20 percent of shares voted against them or withheld, which is nearly double the rate for 2008.[9]

  Surprisingly, none of the directors who failed to obtain a majority vote has resigned, as the director either serves at a company with pure plurality voting or at a company with a "plurality plus resignation" policy where the board did not accept the resignation.[10] It will be interesting to see whether these companies are targeted with additional shareholder activism in the coming year.

- *Decide Whether to Use E-proxy*. The elimination of broker discretionary voting may further discourage companies from taking advantage of the SEC's e-proxy rules because of the dramatic decline in voting by retail investors of those companies using e-proxy. The response rate of shares voted by retail shareholders during the 2009 proxy season of companies using the notice-only method of e-proxy was *half* that of retail shareholders of companies that delivered full sets of their proxy materials in paper form.[11]

In response to the low retail turnout at companies using e-proxy, the SEC has proposed rule changes that are designed to reduce shareholder confusion regarding e-proxy. The rule changes, which may go into effect for the 2010 proxy season, will give companies more flexibility in the formulation of the notices and also allow explanatory materials to accompany the notice. It remains to be seen, however, whether these changes will increase retail participation.

- *Understand Institutional Investor Base and Proxy Advisor Policies*. The influence of institutional investors will likely increase as a result of the elimination of broker discretionary voting, as institutional shareholders are more likely than are retail investors to vote their shares. Consequently, boards should be sensitive to the "hot buttons" that are likely to trigger the wrath of major institutional investors. Also, since institutional investors often follow the advice of proxy advisory firms, these firms will gain more clout. In recent years, proxy advisory firms, such as RiskMetrics Group, have increasingly recommended that their clients withhold votes or vote against director nominees of companies that do not abide by the advisory firm's corporate governance policies. Because advisory firms can often sway a significant portion of a company's votes, directors need to understand these firms' policies and the types of director actions that can result in a negative recommendation. RiskMetrics, for example, will recommend a withhold vote for a wide variety of reasons, including poor pay practices, service by a director on too many boards, a board's refusal to implement a shareholder proposal that received majority support and a board's adoption of a poison pill without shareholder approval.

- *Plan for Additional Time and Expenses and "Get Out the Vote" Efforts*. The rule change will increase the cost of the annual meeting for companies that abandon the less-expensive option of e-proxy. Also, many companies will find that they need to spend more time and effort wooing shareholder votes, especially those of retail investors, to ensure a successful meeting. Companies with heavy retail concentrations, in particular, should consider allowing additional time between the date of mailing proxy materials and the annual meeting date to allow for additional follow-up mailings and telephone solicitations to get out the vote. Recent studies show that few retail shareholders understand the proxy voting process,[12] and companies will need to spend time and effort educating retail shareholders on the importance of their vote.

- *Make Sure Quorum is Obtainable*. Many companies, particularly those with large retail investor bases, rely on broker discretionary votes to reach a quorum. Consequently, companies should make sure that they have at least one "routine" matter on the agenda (such as ratification of auditors), so that brokers can cast votes that can be counted for purposes of determining a quorum.

- *Monitor Proxy Access*. Boards of all public companies will need to monitor developments regarding proxy access during 2010. The SEC is expected to adopt some version of proxy access in 2010. Assuming proxy access is adopted, the new rules could potentially apply to annual meetings held in the latter part of 2010 and, in any event, are expected to be in effect for 2011.

2. Risk Management

Risk management took center stage in most boardrooms during 2009 and will continue to be a high priority for directors in 2010. In the wake of the financial crisis, the board's role in overseeing risk management is drawing the attention of shareholders, regulators and Congress. In December 2009, the SEC adopted rule changes requiring companies to describe in their proxy statements the board's role in risk oversight, as well as how a company's compensation policies may affect risk-taking by employees where those risks are reasonably likely to have a material adverse effect on the company. In addition, pending legislation in Congress would require public companies to establish risk committees composed of independent directors that would be responsible for the establishment and evaluation of risk management practices.

Shareholders are also focused on risk management, and directors at many companies have been targeted with shareholder lawsuits claiming that directors failed to adequately foresee or steer their companies through the financial crisis. Directors of Delaware corporations, however, can take great comfort in a 2009 decision by the Delaware Chancery Court dismissing shareholder claims that Citigroup's directors breached their fiduciary duties by failing to properly monitor and manage the risks associated with Citigroup's exposure to the subprime mortgage crisis.[13]

Under Delaware law, directors have a duty of oversight that requires them to implement and oversee the operation of reasonable information and reporting systems or controls designed to inform them of material risks. However, directors will not be held liable for breach of this oversight duty unless they acted in bad faith by either completely failing to implement any such system or, having implemented such a system, consciously failing to monitor or oversee its operations or warnings it provides.[14] In dismissing the claims against the Citigroup directors, the court clarified that this duty of oversight is not designed to subject directors to personal liability for failure to predict the future and to properly evaluate business risk. The mere fact that a company takes on business risk and suffers losses—even catastrophic losses—does not establish bad faith. In reaching its decision, the court distinguished between oversight liability with respect to business risks and oversight liability with respect to a company's legal compliance systems, noting another 2009 Delaware court decision that allowed a case against several AIG directors to proceed where it was claimed that the defendants failed to properly monitor alleged pervasive fraudulent and criminal conduct by AIG employees.[15]

While it is clear that Delaware courts will not second-guess directors in assessing and taking business risks on behalf of the enterprise, directors should, nevertheless, remain vigilant in monitoring their company's business risks. In addition to heightened shareholder and regulatory scrutiny, recent events have demonstrated that more diligent risk management is not merely a "best" practice but also a necessary practice to ensure survival of the enterprise.

Proper oversight of risk management encompasses not just the legal and financial risks that audit committees have traditionally overseen but also the full panoply of risks that a company may face. Enterprise risk management (ERM) is the current buzzword applied to a top-down holistic approach to risk management. It addresses all of an enterprise's risks—including operational, financial, strategic, compliance and reputational risks—under one umbrella, in contrast to the more traditional "silo" approach in which each operating function or division tackled risk independently. ERM is not focused simply on risk reduction. Rather, it encompasses an assessment of both upside and downside risks and, thus, helps inform the strategic planning process. There are several frameworks available to assist companies in implementing ERM.[16] In addition, two leading organizations recently issued helpful guidance for boards of directors to steer them through their risk oversight duties.[17]

Regardless of a company's stage in implementing an enterprise-wide risk management framework, boards of directors of all companies should be evaluating the adequacy of their risk management oversight procedures in light of the lessons learned from the financial crisis and with an eye towards the new SEC disclosure requirements. Among other things, directors should address—

- *Director education.* All directors need to have a good understanding of their company's business and the major risks it faces. Without a good grasp of both the upside and downside risks, directors cannot properly oversee the company's strategic direction. Indeed, as part of its oversight function, a board needs to be satisfied that the company's risk appetite, that is, the amount of risk the company is willing to accept in pursuit of stakeholder value, is appropriate for the company.[18] Depending on the particular risks that a company faces, the company may need to beef up its board by adding members with expertise in particular areas of concern. If a company has not yet adopted an enterprise-wide approach to risk management, the independent auditors or an outside consultant can provide the board with a basic overview.

- *Oversight structure.* The board should evaluate the manner in which it oversees risk management. Depending on how large it is and how well it functions, a board may decide to retain overall authority for risk management oversight at the board level.

  At many companies, primary oversight responsibility for risk management is delegated to the audit committee. NYSE listing standards require audit committees of NYSE-listed companies to discuss the company's guidelines and policies regarding risk assessment and risk management, as well as the company's major financial risks and the steps management has taken to monitor and control those risks.[19] Under the NYSE rules, however, the audit committee is not required to be the sole body responsible for risk management and assessment. If other mechanisms are used, the audit committee should review such processes "in a general manner."[20] Of course, audit committees are often already burdened with a host of other responsibilities. Consequently, the boards of some companies have set up separate risk management committees, although only 6 percent of public companies (primarily in the insurance and financial services industries) currently have stand-alone risk committees.[21] Legislation is currently pending in Congress that would require any listed company to have a separate risk committee, composed of independent directors, although the prospects for passage of this legislation are uncertain.[22] In view of the new SEC disclosure requirements regarding risk-taking and executive compensation, many boards will assign to their compensation committees oversight of risk management related to compensation policies.

  Even if primary oversight for monitoring risk management is delegated to a committee, the entire board needs to remain engaged in the risk management process and be informed of material risks that can affect the company's strategic plans. Indeed, given the wide spectrum of risks that most companies face and the myriad board decisions that are permeated by risk considerations, many directors believe that risk management oversight should rest with the entire board. 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.

  The new SEC disclosure rules also require companies to disclose how the board's role in risk oversight affects the board's leadership structure. Consequently, a board will need to address, for example, the interplay between its risk oversight function and its decision to combine or separate the positions of CEO and chairman of the board.

- *Reporting processes.* Directors need to ensure that they are getting the information they need to understand the company's risks, as well as management's assessment of those risks. They also may want to meet privately with the company's principal risk officer and the internal and outside auditors to discuss risk management issues. In the adopting release for the new disclosure requirements, the SEC suggested that companies disclose in their proxy statements whether the officers responsible for risk management report directly to the board or to a board committee or how information is otherwise received from such persons. If risk oversight is delegated among several committees, their activities and the sharing of information needs to be coordinated. Also, the board should re-examine how often risk management matters are discussed at board meetings.

- *Risk management review.* The board (or the responsible committee) should review with management the adequacy of the company's risk management practices. In particular, the board needs to probe whether the company's risk management processes appropriately identify, assess and manage the company's risks to ensure that the risk exposures are consistent with the company's appetite for risk.

- *Compensation policies.* As we discuss more fully below, the board (or the responsible committee) should evaluate its compensation policies in light of the company's risk appetite to ensure that employees are not being rewarded for excessive risk-taking.

3. Pay Practices Under Fire

It seems like everyone is taking shots at executive compensation. The media, investors, regulators, legislators, activists and proxy advisory firms are all intensely scrutinizing company pay practices. Shareholders are also increasingly holding directors (especially those serving on compensation committees) accountable for what are perceived to be poor pay practices. Pay concerns contributed to more than 10 percent of votes being withheld from directors at 50 companies during 2009, and at two companies a majority of votes were withheld from compensation committee members.[23] And in December, Goldman Sachs responded to shareholder objections over its plans to pay large cash bonuses to top executives by substituting stock awards with five-year vesting periods and agreeing to give shareholders a "say on pay" at next year's annual meeting.[24]

We highlight below some of the challenges directors will be facing in crafting executive compensation in 2010.

Enhanced Proxy Statement Disclosures. New SEC disclosure rules that go into effect on February 28, 2010, will require companies to add disclosure in their proxy statements about certain pay practices, including—

- *Risk Analysis*. Companies will have to explain how their compensation policies and practices for employees affect the company's risk and management of risk if the risks arising from those policies and practices are reasonably likely to have a material adverse effect on the company. In determining whether disclosure is required, companies can consider offsetting steps or controls that are designed to limit risks. Accordingly, in light of the new disclosure, compensation committees should review the company's compensation policies for all employees to determine whether the risks arising from those policies are likely to materially affect the company, and, if so, whether any changes should be made or other actions taken to mitigate or manage those risks.

  Depending on the company, some pay practices that might encourage excessive risk-taking include compensation arrangements in which a high portion of annual pay is incentive-based, short vesting periods for equity awards, performance goals that significantly exceed past performance targets and steep payout curves where a very high threshold performance level must be met to earn a payout.[25] RiskMetrics has also recently added risk assessment to its evaluation of a company's pay practices. Some pay practices that RiskMetrics believes might encourage excessive risk-taking include guaranteed bonuses, use of a single performance metric for both short- and long-term plans, lucrative severance packages, high pay opportunities relative to industry peers, disproportionate supplemental pensions and "mega" annual equity grants that provide unlimited upside with no downside risk.[26] Some mitigating factors that RiskMetrics will consider include "vigorous" clawback provisions and "robust" stock ownership/holding guidelines.[27]

- *Compensation Consultant Conflict of Interests*. The role of compensation consultants is increasingly under fire, largely due to concerns regarding conflicts of interest. Many believe a consultant's integrity could be jeopardized when the consultant is hired to do work for a company's compensation committee as well as its management or when management's consultant provides advice on executive compensation as well as additional services and the board does not have its own consultant. Because of these concerns, the SEC will now require companies to disclose, in certain circumstances, fees paid to compensation consultants that played a role in determining or recommending the amount or form of executive or director compensation if they provided more than $120,000 of additional services to the company during the company's fiscal year. In addition, when the compensation consultant provides executive compensation advice to the compensation committee, as well as additional services to the company, companies will have to disclose whether the engagement to provide additional services was made, or recommended by, management and whether the board or compensation committee approved the other services.[28] In addition to the SEC's new disclosure rules, legislation is pending in Congress that would require the independence of compensation committees and their consultants and advisors.[29] In light of the new disclosure requirements, the board or compensation committee should review the company's current practices regarding the use of compensation consultants and determine whether any changes should be made.

Tougher SEC Review of Proxy Statements. Companies will no longer get a "free pass" for failing to comply with the SEC disclosure rules regarding executive compensation. In the past, the SEC had often allowed companies to agree to reflect SEC staff comments regarding executive compensation and CD&A in future filings. The SEC staff recently announced, however, that companies should be prepared to amend their filings if the SEC raises material comments and finds their disclosure deficient.[30] The SEC staff also recently identified two topics on which companies should focus their attention in the coming year:

- *Analysis.* The SEC wants to see better explanation of *why* executive officers were compensated as they were. For example, it is not sufficient for a company to state that its compensation committee used tally sheets or other tools in making compensation decisions. Instead, the company should discuss how the committee used these tools to determine compensation amounts and structures and explain why it reached its decisions. If a committee's pay determinations were simply subjective decisions, the company should say that. If a company based its decision on qualitative factors, these factors should be specifically identified, and the company should explain how these qualitative inputs were ultimately translated into objective pay determinations.
- *Performance Targets.* Many companies seek to avoid disclosure of material performance targets because they believe the disclosure will likely cause the company competitive harm. Absent highly unusual circumstances, however, the staff does not believe that disclosure of performance targets will result in competitive harm *after* the company has disclosed the amounts, especially where the performance targets are tied to companywide financial results that are publicly disclosed. If a company does decide to omit a performance target where disclosure would cause competitive harm, it must disclose with meaningful specificity how difficult or likely it would be for the company or executive to achieve the target.

Say on Pay. It looks like say on pay is here to stay. Shareholder proposals calling for an annual shareholder advisory vote on executive compensation were the hottest item on corporate ballots in 2009, with 76 proposals going to a vote.[31] Support averaged 45.6 percent, up 4 percent over 2008, and 22 proposals received majority support, which is double the number of proposals receiving majority votes in 2008.[32] Even if a company has not been targeted with a shareholder proposal on the subject, pending say on pay legislation in Congress is considered likely to pass, although not in time for the 2010 proxy season.[33]

In addition to the pending legislation that would affect all public companies, legislation has already passed that requires financial institutions receiving TARP money to provide shareholders with an annual nonbinding say on pay vote.[34] In 2009, over 300 financial institutions receiving payments under TARP held say on pay votes at shareholder meetings. In addition, at least 25 companies have now agreed, either voluntarily or in response to a shareholder proposal, to give shareholders an annual say on pay.[35] Significantly, shareholder support for company pay programs has been quite high, with an average of 89.75 percent of votes cast in favor of the company's executive compensation programs.[36] No company to date has received a majority vote against its compensation programs.[37]

Further, recent guidelines announced by RiskMetrics appear to be designed to encourage boards of directors to give shareholders a say on pay. As discussed below, if a company has what RiskMetrics considers to be "problematic" pay practices, RiskMetrics will generally recommend a vote against a management proposal asking shareholders to approve the company's compensation practices rather than withhold votes from compensation committee members.

Rather than agreeing to an annual vote on say on pay, some companies are taking slightly different approaches to appease shareholders. These approaches include gathering shareholder views on director and executive compensation by submitting a survey to shareholders (Schering-Plough, Lockheed Martin, Northrop Grumman) and agreeing to give shareholders a biennial (Prudential, Pfizer) or triennial (Microsoft) say on pay, rather than an annual vote.[38]

Other Legislative Initiatives. Congress is currently considering several bills aimed at many of the same executive compensation practices that activists are attacking with shareholder proposals.[39] Although the timing of any such legislation is unknown, companies should monitor legislative developments and be prepared for legislation to pass in 2010 that will affect executive compensation in some manner. The primary legislative initiatives addressing executive compensation include (1) mandatory say on pay for all public companies, (2) a shareholder vote on golden parachutes triggered by a change of control, (3) compensation committee and compensation consultant and advisor independence and (4) policies requiring clawback of incentive-based compensation for noncompliance with financial reporting requirements.

Proxy Advisor Policies. Directors also need to be aware of the positions of proxy advisory firms regarding pay practices. If RiskMetrics determines that there is a disconnect between a company's performance and the CEO's pay under RiskMetrics' criteria, it may recommend against a management proposal asking shareholders to approve the company's compensation practices and, in certain situations, may recommend withholding votes from compensation committee members. Also, if a company has what RiskMetrics considers to be "problematic" pay practices, RiskMetrics will generally recommend a vote against a management say on pay proposal and will generally recommend withholding votes from compensation committee members (or, in some cases, the entire board) in egregious situations or when a say on pay proposal is not on the ballot.[40] Certain pay practices that RiskMetrics considers to be most problematic and that could result in negative recommendations in the absence of mitigating factors, include—

- egregious employment contracts, including contracts that contain multiyear guarantees for salary increases, non-performance-based bonuses and equity compensation
- abnormally large bonus payouts without justifiable performance linkage or proper disclosure
- excessive or overly generous perquisites, including perquisites for former or retired executives
- excessive severance and/or change in control provisions, including single trigger change in control provisions or payments exceeding three times base salary and bonus
- tax reimbursements and excise tax gross-ups.[41]

In light of the impact that a negative voting recommendation can have on directors, particularly with the loss of broker discretionary voting, compensation committees should identify any of the company's compensation practices that RiskMetrics frowns upon and determine whether the practice is still appropriate.

Clearly from the breadth of these areas of focus, directors need to spend some time carefully reviewing their company's pay practices and related disclosures. Among other things, directors should—

- make sure their proxy disclosure clearly justifies the company's pay policies and decisions
- ensure that pay practices do not encourage excessive risk-taking
- review how compensation consultants are used
- consider reaching out to major shareholders to understand their pay concerns and explain the company's positions
- consider limiting or eliminating those compensation practices that typically raise shareholder ire, including tax gross-ups, excessive perquisites, single trigger change of control provisions and excessive severance packages
- monitor legislative and regulatory developments.

4. Strategic Planning Challenges in 2010

One of the most important functions of the board of directors is oversight of the development and implementation of corporate strategy. During the past year, most companies have had their hands full simply dealing with the day-to-day fallout from the financial crisis and recession. As the crisis wanes and the economy continues to improve, management can begin to focus on the prospects for growth and the company's longer-term strategic planning.

In developing these plans, management and boards will need to carefully assess whether the unprecedented events of the past two years require fundamental changes to the company's strategic direction. Although the credit markets are thawing and the economy is slowly recovering, we will not see a return to the loose lending standards and easy money that marked the earlier part of this decade. Rather, in the new world order, it is clear that risk will be priced higher, leverage will be less tolerated, government regulation will be more pervasive and the American consumer, who had accounted for 70 percent of U.S. gross domestic product, will spend less. One study predicts that once a "new normal" sets in after the end of the recession, American consumers will spend at about 86 percent of their pre-recession levels.[42] Mounting federal deficits will also mark the new economic landscape. Even after record-setting shortfalls in both 2008 and 2009, the Obama administration is forecasting that deficits over the next 10 years will total $9.05 trillion, an amount approaching the $12 trillion current national debt that it took the country more than 200 years to accumulate.[43] Another element in the equation for the "new normal" is the unprecedented governmental support of so many parts of the financial sector, and gauging when and how the government will extricate itself from these markets. And, as the last two years have so clearly demonstrated, an increasingly interconnected world economy will have profound implications for all companies. In light of these developments, it is not surprising that many economists foresee lower average economic growth rates for the United States and the world going forward.

Companies need to take a hard look at the lasting impact that these events will have on the viability of their business models and begin the difficult process of making necessary adjustments. While management has the primary responsibility for developing corporate strategy, it will be critical for the board of directors to take an active role in probing the adequacy of management's plans. This is a process that management and boards will have to revisit often in response to the dynamics of the marketplace.

5. Leadership Structure and Board Composition

In view of new SEC disclosure requirements, boards of public companies will need to take a close look at their leadership structure and the background and qualifications of board members. New SEC rules that go into effect on February 28, 2010, will require companies to disclose in their proxy statements—

- whether the company separates or combines the positions of CEO and chairman of the board

- if the positions are combined, whether the company has a lead independent director and the specific role that such director plays in the board's leadership
- why the company has determined that its leadership structure is appropriate for the company
- the effect that the board's role in risk oversight has on the board's leadership structure
- the particular experience, qualifications and attributes that qualify incumbent directors and nominees to serve on the board
- whether diversity is a factor in identifying director nominees, and, if so, how the diversity policy is implemented and its effectiveness is assessed.

In preparation for the 2010 proxy season, the board (or appropriate committee, such as the nominating and corporate governance committee) should be addressing the type of disclosure that will be required and determining whether any changes are advisable before disclosures are made. Among other things, the board or appropriate committee should consider—

- *Independent Chair*. Boards of companies that have combined the positions of CEO and chairman should evaluate whether to separate the roles, and boards of companies that have separated them should consider whether the chair should be independent. Boards are being pressured by a variety of sources to establish independent chairs. Although the SEC stated in the adopting release that the new disclosure requirement is not intended to influence a company regarding its leadership structure, at least one commentator has skeptically noted that the new rule appears to be another case of "therapeutic disclosure" designed to drive companies towards separating the positions.[44] Legislation has been proposed in Congress that would require listed companies to have an independent, non-executive director serve as chairman, while other proposed legislation would simply require disclosures similar to the SEC mandate.[45] Also, shareholder proposals calling for an independent chairman averaged 36.9 percent support at the 34 companies where the proposal was on the ballot in 2009, up from average approval of 29.3 percent at 28 meetings last season, and a binding proposal at Bank of America's 2009 annual meeting received a majority vote, requiring CEO Ken Lewis to step down from the chairman position.[46]

  Despite pressures to separate the positions, a board should carefully evaluate the optimum leadership structure for its particular company. Various studies comparing the effect on company performance of the two leadership structures are inconclusive.[47] Moreover, only a fraction of U.S. public companies separate the CEO and board chair and even fewer have an independent chair. Thirty-seven percent of S&P 500 companies have separated the positions,[48] and less than half of these companies have an independent chair.[49] Consequently, only 16 percent of all S&P 500 companies have an independent chair.[50] In almost all instances where the chairman is separate but not independent, a current or former executive of the company fills the chairman's seat.[51]

- *Lead or Presiding Director*. In lieu of, or in addition to, separating the positions of CEO and chairman, many companies have established a lead or presiding independent director, who, among other things, helps set board agendas, runs executive sessions of the independent directors and serves as a liaison between the independent directors and management. NYSE-listed companies are required to have a non-management director preside over executive sessions of the non-management directors, but the same director is not required to preside at all such sessions.[52] Ninety-five percent of S&P 500 companies have designated a lead or presiding director,[53] and almost all S&P 500 companies that do not have an independent chairman have a lead or presiding director.[54]

At 89 percent of these companies, a single individual fills the role, while at the other 11 percent, the role is rotated among independent directors at each board meeting.[55]

- *Responsibilities of Lead Director*. Companies that have a lead director but a combined CEO/chairman should review the responsibilities assigned to the lead director in view of the new required disclosure about the role that such a director plays in the board's leadership structure.[56] The company's corporate governance guidelines may need to be updated or revised to reflect the lead director's role.
- *Director Qualifications*. In view of the new SEC requirement to disclose the particular experience, skills and attributes that qualify incumbent directors and nominees to serve on the board, companies will likely need to gather additional information from their directors. In addition, the nominating committee should assess whether the board has the appropriate mix of experience and skills to address the company's business needs and challenges and whether the company's corporate governance guidelines need to be revised to reflect the desired board composition.
- *Diversity*. Companies will also need to disclose in their proxy statements whether—and, if so, how—the nominating committee or board considers diversity in identifying director nominees. If there is a diversity policy, the company must disclose how the policy is implemented and how the nominating committee or board assesses its effectiveness. The new SEC disclosure rules do not define diversity, and the SEC expressly noted that some companies may view diversity expansively to include differences of viewpoint, professional experience, skills, education and other attributes that contribute to board heterogeneity, while others may focus on race, gender or national origin.

  Many companies already state in their corporate governance guidelines that they seek a variety of skills and attributes in determining board makeup. Some companies also expressly mention gender, race and nationality.[57] Eighty-nine percent of S&P 500 companies now have at least one woman director,[58] although women comprise only about 15 percent of all directors serving on S&P 500 company boards.[59] Minority representation accounts for 10 percent of these boards.[60]

  Since the new SEC disclosure requirements give companies broad leeway in defining diversity, the nominating committee or board should carefully consider those qualities or attributes that are most appropriate for the company, given its particular circumstances. If diversity is a factor in determining board makeup, the company's corporate governance guidelines and, if appropriate, nominating committee charter should reflect the qualities and attributes that the company seeks. In deciding how to implement a diversity policy, the nominating committee or board should be wary of setting specific quotas that it may not be able to meet due to a shortage of viable candidates who also possess other qualities or attributes that the company considers important.

6. The Return of M&A

After an abysmal 2009, M&A is poised for a comeback. For the nine months ended September 30, 2009, U.S. M&A activity totaled just $601.2 billion, down 46 percent from the prior year's comparable period.[61] Similarly, on a global basis, M&A activity totaled just $1.46 trillion through the first nine months of 2009, a 38 percent decline from 2008 levels.[62] In 2007, at the peak of the merger boom, full-year M&A hit $4.28 trillion.[63] Even though the stock market has rebounded sharply from the lows of 2008, deal-making has continued to suffer due to uncertainty about the economy, companies' desire to hoard cash and lack of available credit. The leveraged loan market, however, is beginning to show signs of life, with several large acquisitions by financial buyers being announced in the past month.

With credit markets gradually improving, M&A activity should rebound during 2010. There is a tremendous amount of strategic capital waiting to be deployed. Companies currently have the most cash on hand as a percentage of total assets since 1951,[64] and CEOs are more willing to put the cash to work now that the economic outlook is less uncertain. A recent study by Ernst & Young of nearly 500 senior executives around the world shows that 33 percent of companies are likely or highly likely to make an acquisition during the next 12 months.[65] Private equity firms, forced to sit on the sidelines for most of 2009 due to the lack of available leverage, are feeling increasing pressure to deploy the estimated $400 billion they have amassed.[66] While they wait for the LBO market to improve, private equity shops have been stepping up their investments in distressed companies, making more minority investments and shoring up their portfolio companies. In recent weeks, PE firms have even announced several billion-dollar LBOs, although with less leverage and more stringent financing terms than for deals in the years leading up to the financial crisis.[67]

As management and boards continue to sharpen their strategic focus, we expect to see more companies shedding underperforming or noncore assets, while other companies will be seeking growth opportunities that may not be available organically in the current economy.[68] To be sure, we will not see a return to anywhere near the giddy highs of 2007, but, with the current attractive valuations, companies should be poised to seize opportunities as the credit markets continue to loosen.

Even if the rest of the M&A market does not rebound, acquisitions of distressed companies should remain strong. Through the first 10 months of 2009, bankruptcy deals totaled $255 billion, compared to $43.3 billion during the same period last year.[69] With the pace of bankruptcy filings showing no signs of slowing,[70] companies with cash and private equity firms will find plenty of opportunities to pursue Section 363 asset sales and other distressed transactions.

7. Shoring Up Takeover Defenses

The flip side of increasing M&A activity is that many companies will find themselves at risk of becoming targets of unwanted suitors. Although the stock market has rebounded from the lows of 2008, stock prices for many companies are still below historical averages, making the companies attractive takeover targets. Also, many companies in recent years have dismantled their takeover defenses, often in response to shareholder activism, leaving them vulnerable to takeover threats. In this environment, directors need to carefully assess the adequacy of their company's takeover defenses. Four defenses that are receiving a lot of attention are: poison pills, classified boards, denial of shareholders' right to call special meetings and advance notice bylaws.

Poison Pill. The use of poison pills as a takeover defense has been falling out of favor for several years, but many companies are now having a change of heart regarding this potent defense, as evidenced by the 60 companies that adopted new poison pills in 2009.[71] We highlight below some considerations that boards should take into account when deciding whether to adopt a poison pill:

- *RiskMetrics' Position*. For those boards considering adopting a poison pill, directors need to be aware of guidelines established by RiskMetrics Group, which continues to take a strong position against poison pills. RiskMetrics' 2010 policy updates actually strengthen its stance with respect to "long-term" poison pills. Previously, a board that adopted a pill with a term of more than 12 months could avoid a negative recommendation from RiskMetrics by committing to submit the pill to shareholders for ratification within 12 months of its adoption. Now, however, RiskMetrics will generally recommend a withhold/against vote for all directors of a company that, without shareholder approval, adopts a poison pill with a term of more than 12 months or renews any existing pill regardless of the pill's length.[72] A board's commitment to put a newly adopted pill to a binding shareholder vote may only potentially offset an adverse vote recommendation. And for those companies that adopt, rather than renew, a pill with a duration of 12 months or less without shareholder approval, RiskMetrics will evaluate directors on a case-by-case basis.[73] Further, companies that unilaterally adopt a poison pill will be subject to reviews at least once every three years (or every year for companies with classified boards), beginning the first year after the adoption and extending until the pill has expired or been redeemed. This new policy will apply to companies adopting or renewing poison pills after November 19, 2009.[74] RiskMetrics also expects companies to include certain shareholder-friendly provisions in their poison pills.[75] Although directors should be aware of RiskMetrics' position on poison pills, they need to remain focused on what is in the best interests of the company's shareholders.

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

- *Derivative Positions/Beneficial Ownership*. As investors have significantly increased their use of derivative, swap and other transactions, often accumulating large positions in a company without having to disclose these positions publicly, some companies have adopted or amended poison pill language to cover these derivative positions when calculating an investor's ownership under the poison pill. Companies should be cautious when considering this type of language in a poison pill because including derivative positions in the calculation of beneficial ownership under a poison pill is an emerging concept and has not been addressed by the Delaware courts.[76] In addition, the lack of public disclosure on derivative positions could make it difficult for companies to monitor when a shareholder has triggered the pill, and the possibility of inadvertent triggers could increase.

- *NOL Poison Pills*. In addition to deterring hostile takeovers, an increasing number of companies have adopted poison pills to preserve their net operating loss carryforwards (NOLs). Due to the recession, more and more companies are accumulating NOLs that, if preserved, can be used in future years to reduce income tax liability. However, the benefit of NOLs decreases significantly or is eliminated if there is an "ownership change" of the company.[77] To prevent losing the benefit of NOLs, an increasing number of companies are adopting poison pills with a low triggering threshold, typically just under 5 percent, to deter stockholders from increasing their ownership and triggering an "ownership change." As of November 2009, 41 U.S. companies had adopted a poison pill—or amended an existing pill to decrease the triggering threshold—to preserve the company's ability to use its NOLs. This number reflects a significant increase, with only 12 companies adopting an NOL poison pill in 2008 and five companies adopting such a pill in 2007. RiskMetrics' policy does give companies some leeway regarding NOL poison pills by reviewing them on a case-by-case basis.[78]

Classified Boards. The classified board is a traditional takeover defense where directors are divided into separate classes and only a fraction of directors (typically one-third) are up for election each year. RiskMetrics and several other proxy advisory firms view classified boards unfavorably and almost always recommend voting for a proposal to declassify a company's board, so all directors are elected annually. During 2009, activist shareholders placed 63 proposals to repeal classified boards on company ballots and received strong shareholder support, with an average of

65.6 percent of votes cast supporting board declassification.[79] Also, in response to pressure from activists, management submitted 29 declassification proposals to shareholders in 2009.[80] Largely due to pressure from activists, the number of companies with staggered boards has decreased significantly over the past few years, with only 34 percent of companies in the S&P 500 retaining a classified board.[81] And this percentage could change dramatically if current legislation passes that would either ban classified boards or permit classified boards only with shareholder approval or ratification.[82]

Companies with classified boards should think carefully before succumbing to shareholder pressures to declassify the board, particularly in the current economic environment in which many companies are vulnerable to bottom-fishing offers. A classified board provides a company with additional leverage against a potential hostile acquiror because the acquiror is unable to gain control of a majority of the board at a single annual meeting. A classified board also strengthens the deterrent effect of a poison pill because an acquiror cannot replace a majority of the board at a single election and then redeem the pill. Further, under Delaware law, if a board is classified, directors can only be removed "for cause," which has proven difficult to demonstrate, making it a fairly unrealistic option for activists desiring to remove directors.

Denial of Shareholders' Right to Call a Special Meeting. Most public companies have provisions in their charters that deny shareholders the right to call a special meeting, or they may give shareholders this right, but provide that only a high percentage of shareholders may call a special meeting. But all this could change as more and more activists put pressure on companies to give shareholders this right. In 2009, 61 shareholder proposals seeking a shareholder right to call special meetings made it on company ballots, receiving average support of 50.8 percent,[83] a substantial increase from the 23 proposals in 2008 that received average support of 46.6 percent.[84] For those companies that currently give shareholders the right, you may not be off the hook. Activists are targeting not only companies that currently deny shareholders the right to call a special meeting, but also companies that actually give shareholders the right—but require a higher stock ownership threshold than desired by activists, who typically seek a 10 percent threshold. Many such companies have tried to exclude these proposals from their proxy statements, arguing that they have "substantially complied" with the proposal, but the SEC has rejected this argument because of the difference in the stock ownership threshold.[85] A strategy that companies may want to consider if faced with this shareholder proposal is to include in the company's proxy statement a company proposal giving shareholders the right to call a special meeting, but at a higher stock ownership threshold. The company may then be able to exclude the shareholder proposal with the smaller percentage threshold on the basis that it conflicts with the company proposal.[86] This tactic could be particularly helpful if the company is at risk of an against/withhold recommendation for all director nominees from RiskMetrics for failure to act on a shareholder proposal that received approval of a majority of shares cast for the previous two years.[87]

Advance Notice Bylaws. Another takeover defense that directors should carefully review, is the company's advance notice bylaws,[88] particularly in light of two 2008 Delaware court cases narrowly interpreting their effect.[89] These decisions highlight how important it is that advance notice bylaw provisions clearly and accurately reflect the company's intent by, among other things, clearly applying to all proposals to be made at shareholder meetings, whether or not the shareholder wishes to have the proposal included in the company's proxy statement pursuant to Rule 14a-8.[90]

In addition, companies should consider requiring shareholders who attempt to present proposals or nominate directors at a shareholder meeting to provide the company with additional information about any hedging or similar arrangements that have the effect of increasing or decreasing the shareholder's economic or voting power, any arrangements between the proponent and others concerning the proposal, and the proponent's relationship with the company and any significant shareholders. Companies should also consider requiring that this information be updated as of the record date and as of 10 days preceding the meeting. Requiring this information from shareholder proponents gives the company and shareholders valuable insight into the proponent's motives and will help the company and shareholders evaluate the proposal. Although collecting this information is helpful, companies need to be careful that the provision is not so onerous that it could be found to be invalid.[91]

Finally, if the SEC adopts final rules on proxy access, all companies will need to revisit their advance notice bylaws and possibly adopt new proxy access-related bylaws in 2010.

Other Considerations. As discussed more fully below, companies considering adopting a majority vote standard for the election of directors should think twice. With the elimination of broker discretionary voting in uncontested director elections in 2010, achieving the required majority vote for directors may become more problematic, particularly for those companies with a large retail shareholder base that often allows the broker to vote their shares. Legislation is currently pending that would require all listed companies to apply majority voting in uncontested elections of directors.[92]

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

8. Succession Planning

Evaluating and selecting a company's CEO is one of a board's most significant responsibilities. Replacing the CEO, whether due to a planned retirement, forced resignation or sudden departure, is critical to the future of the company. And boards are finally starting to take notice. According to the 2009 Spencer Stuart Board Index, 45 percent of boards surveyed cited CEO succession planning as an issue requiring significant board focus, an increase from 19 percent in 2008.[93] But even with this increased focus, many boards still do not devote enough time and attention to succession planning. A recent survey by PricewaterhouseCoopers revealed that 39 percent of directors surveyed are not satisfied with their company's succession plan and 53 percent indicated they would like to spend more time on succession planning this next year.[94] And in today's tough economic environment, it would probably be wise for all boards to do so.

Shareholders will also be calling on companies to address succession planning. In November 2009, the SEC announced that it will now require companies to include in their proxy statements shareholder proposals seeking disclosure about a company's CEO succession planning policies.[95] Previously, the SEC had allowed companies to exclude these proposals.[96]

With the importance placed on CEO succession, it is surprising how many boards fail to have an effective plan in place. Boards often push CEO succession planning to the back burner, perhaps because the current CEO is performing well, so they think succession planning can wait, or because it involves uncomfortable conversations with the current CEO, or because much of a board's time is spent addressing more pressing day-to-day obligations. Whatever the reason, boards need to devote sufficient time and attention to establishing a credible succession plan, so the company has viable candidates ready to step up if given the opportunity.

Bank of America is just one recent example of a company that struggled to find a successor to its CEO, who announced plans to step down at the end of the year. With no succession plan in place, the company searched for months to find a willing successor capable of effectively handling the company's financial and legal challenges.[97]

The situation at Bank of America can be contrasted sharply with the situation McDonalds faced in 2004. McDonalds had to replace two CEOs within a period of eight months: one who died unexpectedly and one who stepped down a few months into his tenure after being diagnosed with cancer.[98] In both circumstances, McDonald's board was able to instill confidence in shareholders and analysts by immediately announcing a successor who was well-qualified and able to lead the company effectively through the transition.

So what should boards be doing? First of all, directors should periodically have in-depth discussions on CEO succession, preferably quarterly but at least once a year. In these discussions, directors should consider several factors, including the company's strategy (e.g., is the company going through a turnaround or an expansion?), the industry and particular challenges facing the company. This discussion should help give boards a better understanding of the leadership talent and skills necessary for the position. Once this is understood, the board should identify potential candidates, both internal and external. Boards should not wait for a CEO vacancy to get to know the candidates and their strengths and weaknesses. If the candidates are internal, the board should take a proactive role in grooming candidates for the position by ensuring they have the right leadership skills and are receiving necessary training for the CEO role.

To minimize the disruption of a CEO's departure, boards should also have a process in place that details the procedures and governance response necessary once a CEO has announced his or her departure. The departure of a CEO has a significant impact on an organization's operations, culture and morale, and the failure to have an effective plan to handle the situation can damage the company's credibility and erode shareholder value.

9. Cultivating Shareholder Relations

With shareholders, regulators and legislatures all calling for more transparency and accountability for public company boards, it is critical that directors understand who their company's shareholders are and what they care about. Cultivating good shareholder relations will be all the more important in 2010 with proxy access and say on pay looming on the horizon for 2011.

The 2010 proxy season is expected to be another banner year for shareholder activism. Popular proposals for 2010 will likely mirror those for 2009, in which the most common proposals included say on pay (76 proposals with support averaging 45.6 percent), calls to eliminate classified boards (63 proposals with support averaging 65.6 percent) and proposals to give shareholders the right to call special meetings (61 proposals with support averaging 50.8 percent).[99]

Companies will also see an increase in shareholder proposals relating to risk management and CEO succession as a result of a recent change in SEC guidance on whether companies must include these types of shareholder proposals in their proxy statements. An SEC rule allows companies to exclude shareholder proposals that simply relate to the "ordinary business" of the company. Previously, the SEC had generally allowed companies to rely on this rule to exclude proposals that would require a company to engage in an internal assessment of risks and liabilities that the company faces as a result of its operations. Going forward, however, the SEC will not allow companies to exclude a proposal relating to internal risk assessment if it "transcends the day-to-day business matters of the company and raises policy issues so significant that it would be appropriate for a shareholder vote."[100] The SEC expressly noted that a proposal focusing on the board's role in the oversight of risk management may be just such a proposal. As noted above, the SEC also will no longer allow companies to exclude from their proxy statements shareholder proposals focused on CEO succession planning. The SEC's new policy will also likely result in more shareholder proposals concerning social policy and environmental matters making their way onto company ballots.

While the 2010 proxy season is expected to see an increase in shareholder proposals, effective communications between companies and their shareholders could help minimize the number of these proposals that actually go to a vote. In 2009, more than a third of proposals were omitted or withdrawn,[101] with management and shareholders often coming to an agreement after an open dialogue on the proposal. Most shareholders prefer to have meaningful discussions with management rather than fighting it out at an annual meeting. Such a willingness to communicate with shareholders shows that the board and management are responsive to shareholder concerns.

Rather than waiting for shareholders to contact them, many companies are proactively taking the initiative to develop stronger relations with their investor base. In a 2009 survey of S&P 500 companies, two-thirds of survey respondents reported that their management or boards had reached out to shareholders to solicit their input.[102] Forty-four percent reported that the contacts were initiated with large institutional investors and/or top 50 shareholders to discuss proxy recommendations and/or governance matters, while other communications with large shareholders focused on business performance and strategy.[103] In addition to cultivating relationships with major investors, companies need to make sure that they are effectively communicating their business strategies to the marketplace, and they should also be taking advantage of the power of the Internet by making sure their Web sites are up-to-date and fully communicating the company's message. In addition, companies should be actively monitoring shareholder concerns and opinions that are expressed through blogs and other shareholder forums and proactively responding to any shareholder issues before they escalate.

10. Monitoring Legislative and Regulatory Developments

As is apparent from our discussion of the other topics in this alert, boards will need to stay abreast of pending legislation and government regulations dealing with executive compensation and corporate governance. Whether it relates to say on pay, majority voting, classified boards, compensation consultants or proxy access, the effects of any final laws or regulations in these areas will be felt by all public companies.

Many companies may have already had to deal with these reform initiatives as a result of pressure from shareholders or proxy advisory firms. However, to the extent companies can sit back and let the game play out, they probably should do so. It is almost guaranteed that companies will soon be subject to additional legislation and regulations on corporate governance, but until Congress and the SEC flesh these out, it is difficult to determine how far they will go and what changes will be necessary. A company that implements major changes now in areas such as proxy access or say on pay may find that its efforts fall short of, or conflict with, the final legislation or rule. That being said, it is highly likely that some form of proxy access and say on pay will be adopted next year, and, in shaping their actions, boards should be mindful of the increasing voice that shareholders may have.

In addition to executive compensation and corporate governance matters, the SEC is expected to fix problems with the proxy system's "plumbing" next year. The SEC plans to issue a concept release in the next few months seeking input on, among other things: ways to address the voting rate by retail investors; ways to ensure accuracy in vote tabulation; whether votes are cast by those with an economic interest in the shares; and whether rules are needed to ensure that proxy advisory firms base their research and recommendations on accurate and reliable information and provide adequate disclosure of any conflicts of interest they may have in providing voting recommendations.[104] This last topic will be particularly welcomed by many companies, who believe that proxy advisory firms wield too much power. For example, a recent study revealed that there is little or no correlation between a company's corporate governance rating and the company's performance and that recommendations made by different proxy advisory firms vary substantially.[105] Further, concerns have been raised about potential conflicts of interests relating to consulting done by proxy advisory firms.[106]

In addition to corporate governance and executive compensation reform, boards will also need to monitor other major legislative initiatives that could significantly impact companies, including health care, energy policy and financial industry reform:

- *Health Care Reform*. Health care reform continues to monopolize the news as Republicans and Democrats battle out what should be included in the health care reform bill. Whatever legislation, if any, that ultimately emerges from Congress will undoubtedly affect not only the health care industry, but also all employers and the manner in which they provide health care to employees.
- *Energy Policy Reform*. Despite recent skepticism over some of the scientific data on global warming and difficulties in obtaining a binding global pact at the Copenhagen summit, Congress is still feeling pressure to adopt some form of climate change legislation. On December 7, the EPA declared that greenhouse gas (GHG) emissions are pollutants that pose a danger to the public health and, therefore, can be regulated under the Clean Air Act. The EPA action, which sets the stage for potential regulation of GHG emissions pursuant to existing laws, is seen by many as a tactic to pressure Congress into adopting comprehensive climate change legislation that would cap national carbon emissions and include some form of cap-and-trade program. If a company's management and board have not already done so, they need to develop a comprehensive strategy for addressing climate change issues, including climate change risks and any opportunities that climate change may present to the company.
- *Financial Industry Reform*. Current pending legislation seeks to reform the entire U.S. financial regulatory structure, including reforming regulatory agencies, financial institutions, financial products and bank capital requirements. Further, proposed legislation would also increase the regulation of private equity and hedge funds. Although financial institutions will be most affected, such reform is also likely to affect other companies by restricting available credit, increasing borrowing costs and increasing costs for derivative contracts.

It is critical that directors stay abreast of the various legislative and governmental initiatives and the changes being proposed. The impact these reform initiatives will have on companies will vary significantly depending on the company and the industry. Boards need to determine how pending legislation and regulation could affect their companies, so they can begin strategizing on how to deal with the challenges the company might face in the future. If the challenges are significant enough, boards may want to consider launching or stepping up their lobbying efforts in hopes of influencing the direction of the legislation.

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[1] *See* sharkrepellent.net, "Proxy Fight Trend Analysis" and "Proxy Fights 2009" (as of December 8, 2009).
[2] *Id*.
[3] The proposed rules require shareholders to submit their director nominees to the company at least 120 days in advance of the anniversary of the date the company mailed its prior year's proxy statement. Consequently, even if the rules are adopted in early 2010 and go into effect 60 days after publication in the *Federal Register*, they will not have an effect on companies that hold their annual meetings in the spring of 2010.
[4] *See* Broadridge, 2009 Proxy Season: Key Statistics & Performance Ratings: July 2009.
[5] *Id*.
[6] *See* A. Barrett and B. Young, "Majority Voting for Director Elections: Not Yet Standard," *Corporate Governance Advisor* Vol. 17, No. 1 (Jan./Feb. 2009) (citing 2008 study by The Corporate Library showing that 49 percent of S&P 500 companies have a true majority voting standard requiring a nominee to receive at least a majority of the votes cast in order to be elected, and another 18 percent of S&P 500 companies have a "plurality plus resignation" standard providing that a director is elected based on a plurality of the votes cast, but the director must tender a resignation if the director does not receive a majority of the votes cast with respect to his or her election. At Russell 1000 companies, 33 percent have true majority voting and 13 percent have plurality plus resignation policies.)
[7] T. Allen, "A Closer Look at High Withhold Votes," RiskMetrics Group (Oct. 2, 2009), available at http://blog.riskmetrics.com/2009/10/a_closer_look_at_high_withhold.html.
[8] *Id*.
[9] Proxy Governance, Inc. News Release "Shareholder Votes Opposing Director Nominees Show Sharp Increase in 2009 Proxy Season" (Sept. 19, 2009) (9.8 percent of unopposed director nominees had at least 20 percent of shares voted against them or withheld, up from 5.5 percent in 2008). *See also* Georgeson, *2009 Annual Corporate Governance Review*, available at http://www.georgesonshareholder.com/usa/acgr09.php (at S&P 1500 companies, 1,027 directors at 378 companies had 15 percent or greater votes withheld or cast against them, 786 directors had withhold/against votes of 20 percent or greater, 469 directors of 30 percent or greater, 223 directors of 40 percent or greater, and 79 directors of 50 percent or greater).
[10] *See* J. S. Lublin, "Directors Lose Elections, But Not Seats," *The Wall Street Journal* (Sept. 28, 2009); Georgeson, *supra*.
[11] *See* Broadridge Notice & Access, Statistical Overview of Use with Beneficial Shareholders (as of June 30, 2009) (for the 12 months ended June 30, 2009, 15.28 percent of shares held by retail shareholders who received notice only were voted, compared to 31.95 percent of shares held by retail shareholders at companies that did not use notice and access).
[12] *See* Investor Attitude Survey referenced in the SEC release approving the amendment to NYSE Rule 452, SEC Rel. No. 34-60215 (July 1, 2009), at p. 25, n. 91, available at http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf.
[13] *In re Citigroup Shareholder Derivative Litigation*, 2009 WL 481906 (Del. Ch. Feb. 24, 2009).
[14] *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).
[15] *American International Group, Inc. Consolidated Derivative Litigation*, 2009 WL 366613 (Del. Ch. 2009).
[16] *See*, e.g., the ERM framework adopted by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), available at http://www.coso.org/documents/COSO_ERM_ExecutiveSummary.pdf. *See also* The Conference Board, "Emerging Governance Practices in Enterprise Risk Management" (Feb. 2007).
[17] COSO, "Effective Enterprise Risk Oversight, The Role of the Board of Directors 2009," available at www.coso.org; National Association of Corporate Directors, Blue Ribbon Commission Report on Risk Governance: Balancing Risk and Reward (2009).
[18] *See* COSO, "Effective Enterprise Risk Oversight, The Role of the Board of Directors 2009," *supra*.
[19] NYSE Listed Company Manual §303A.07(c)(iii)(D) and related Commentary.
[20] Commentary to NYSE Listed Company Manual §303A.07(c)(iii)(D).
[21] Directorship, "Risk Oversight: Faster, Higher, Stronger" (Sept. 4, 2009), available at http://www.directorship.com/risk-oversight-faster-higher-stronger/.
[22] Both S. 1074 (Shareholder Bill of Rights Act of 2009), which was introduced by Sen. Charles Schumer in May 2009, and H.R. 3272 (Corporate Governance Reform Act of 2009), which was introduced by Rep. Keith

Ellison in July 2009, call for all public companies to have a separate risk committee. A discussion draft of Sen. Christopher Dodd's bill (the "Draft Dodd Bill") that was released in November 2009 would require risk committees only for certain financial institutions and systemically important companies, and the Corporate and Financial Institution Compensation Fairness Act of 2009, as contained in H.R. 4173 (The Wall Street Reform and Consumer Protection Act of 2009), which passed the House of Representatives in December 2009, does not require risk committees.

[23] RiskMetrics Group, Postseason Report (October 2009), p. 10.

[24] S. Craig, "Goldman Blinks on Bonuses," *The Wall Street Journal* (Dec. 14, 2009).

[25] *See* Frederic W. Cook, "A Compensation Committee Framework for Conducting Executive Compensation Risk Assessments," *Corporate Governance Advisor* Vol. 1, No. 1 (Jan.-Feb. 2009).

[26] RiskMetrics Group, U.S. Corporate Governance Policy 2010 Updates (Nov. 19, 2009), p. 26.

[27] *Id*.

[28] *See* SEC Release No. 33-9089, 34-61175 "Proxy Disclosure Enhancements" (Dec. 16, 2009). The SEC included exceptions to the disclosure requirement for certain services that are not believed to raise significant conflicts of interest concerns, including services involving only broad-based nondiscriminatory plans or the provision of information, such as surveys, that are not customized for the company or are customized based on parameters that are not developed by the consultant.

[29] *See* the Draft Dodd Bill and H.R. 4173.

[30] Speech by Shelley Parratt, Deputy Director, Division of Corporation Finance "Executive Compensation Disclosure: Observations on the 2009 Proxy Season and Expectations for 2010." (Nov. 9, 2009).

[31] RiskMetrics Group, 2009 Proxy Season Scorecard (Results as of December 1, 2009).

[32] *Id*. *See also* RiskMetrics Group, Postseason Report (October 2009), p. 4.

[33] Almost all of the current bills, as well as the Draft Dodd Bill, include some form of say on pay provision.

[34] American Recovery and Reinvestment Act of 2009, Pub. L. 111-5.

[35] RiskMetrics Group, Postseason Report (October 2009), p. 12. In addition, in December, Goldman Sachs agreed to give shareholders a say on pay.

[36] *Id*.

[37] *Id*. *See also* Georgeson, *supra*, at p. 4.

[38] Posting of Broc Romanek to TheCorporateCounsel.net "Say-on-Pay: Prudential Becomes First to Adopt Biennial Model" (Oct. 15, 2009), available at http://www.thecorporatecounsel.net/Blog/2009/10/more-executive-pay-surveys-a-comparison.html. *See also* Brad Smith and John Seethoff, "Microsoft's Board Adopts New 'Say-on-Pay' Policy (Sept. 18, 2009), available at http://microsoftontheissues.com/cs/blogs/mscorp/archive/2009/09/18/microsoft-s-board-adopts-new-say-on-pay-policy.aspx.

[39] *See* the Draft Dodd Bill and H.R. 4173.

[40] RiskMetrics Group, U.S. Corporate Governance Policy 2010 Updates (Nov. 19, 2009), pp. 25-26.

[41] *Id*.

[42] AlixPartners LLP, "Americans Expect Their 'New Normal' Spending Levels to be 86% of Pre-Recession Levels" (2009), available at http://www.alixpartners.com/en/MediaCenter/PressReleases/tabid/58/language/en-US/ItemId/4/Default.aspx. It is believed that the phrase "the new normal" was coined by Mohamed El-Erian of PIMCO.

[43] M. Crutsinger, AP News, "Federal Budget Deficit for November Hits $120.3 B" (Dec. 10, 2009).

[44] ProfessorBainbridge.com, "Should the CEO also be the Chairman of the Board?" (August 4, 2009), available at http://www.professorbainbridge.com/professorbainbridge.com/2009/08/should-the-ceo-also-be-the-chairman-of-the-board.html.

[45] Each of H.R. 2861 (Shareholder Empowerment Act of 2009), which was introduced by Rep. Gary Peters in June 2009, H.R. 3272 and S. 1074 would require companies to have independent chairs, while the Draft Dodd Bill would require companies to disclose the rationale for separating (or not separating) the positions of chairman and CEO in their annual proxy statements.

[46] RiskMetrics Group, 2009 Proxy Season Scorecard (Results as of December 1, 2009).

[47] *See* J. Coates, "Protecting Shareholders and Enhancing Public Confidence Through Corporate Governance" (July 30, 2009), available at http://blogs.law.harvard.edu/corpgov/2009/07/30/protecting-shareholders-and-enhancing-...
[48] Spencer Stuart, 2009 Spencer Stuart Board Index (2009).
[49] *Id*.
[50] *Id*.
[51] *Id*., *see also* Hewitt Associates LLC, "Analysis of 2009 Proxy Season," MarkeTrends 2009-04 (Sept. 30, 2009).
[52] Commentary to NYSE Listed Company Manual Section 303A.03. Effective January 1, 2010, the NYSE rules will be amended to clarify that NYSE-listed companies may hold executive sessions of only the independent directors, rather than all nonmanagement directors.
[53] Spencer Stuart, *supra*.
[54] *Id*. (94 percent of companies that do not have an independent chairman have a lead or presiding director.)
[55] *Id*.
[56] For a discussion of various responsibilities that may be assigned to the lead director, *see* Spencer Stuart, "A Closer Look at Lead and Presiding Directors."
[57] For example, the nominating committee charter for The Coca-Cola Company provides that "diversity of race, ethnicity, gender and age are important factors in evaluating candidates for Board membership." Similar disclosure is included in the company's corporate governance guidelines.
[58] Spencer Stuart, 2009 Spencer Stuart Board Index (2009).
[59] *See* Catalyst Census of Women Board Directors in Fortune 500 (2008), cited in comment letter submitted to SEC by Catalyst (Sept. 15, 2009). The Spencer Stuart Board Index reports that women comprise 16 percent of *independent* directors at S&P 500 companies. Spencer Stuart, *supra*.
[60] *Id*. RiskMetrics will support requests for reports on the company's efforts to diversify the board with respect to race and gender, unless the board composition is already reasonably inclusive relative to its peers, and the board already reports on its nominating procedures and gender and racial minority initiatives within the board and the company. RiskMetrics Group, "U.S. Corporate Governance 2010 Policy Updates" (Nov. 19, 2009). RiskMetrics determines on a case-by-case basis whether to support shareholder proposals asking companies to increase representation of women and minorities on boards, considering such factors as: the current makeup of the board and its executive officers; how the board's composition compares to that of the company's industry peers; whether the board has an established process for improving board diversity, has an independent nominating committee and uses an outside search firm; whether the company has a recent history of controversies, fines or litigation regarding equal employment practices; and whether the proposal includes an overly prescriptive request to amend nominating committee charter language. *Id.* Studies on the effect of gender and racial diversity on a company's financial performance are mixed. *See* D. Rhode and A. Packel, "Diversity on Corporate Boards" (2009) (review of studies on board diversity concluded that "the empirical research on the effect of board diversity on firm performance is inconclusive, as the results are highly dependent on methodology").
[61] Thomson Reuters, "Mergers & Acquisitions Review, Third Quarter 2009."
[62] *Id*.
[63] *Id*.
[64] P. Barker, "Maximizing Your Strategic Advantage: M&A in the 'New Normal,'" Barclays Capital Governance and Leadership Summit (Oct. 15, 2009).
[65] Ernst & Young, "One Third of Global Businesses Actively Seeking M&A Targets in Next 12 Months" PR Newswire (Nov. 11, 2009).
[66] O. Smiddy, "Private Equity Holds Its Cash … And Waits," *The Wall Street Journal* (Aug. 19, 2009). An Ernst & Young report released in December 2009 notes that private equity firms have about $400 billion at their disposal. *See* A. Sorkin, "Looking Ahead to 2010's Deal Landscape," The New York Times DealBook (Dec. 14, 2009), citing report by Ernst & Young Transaction Advisory Services.
[67] J. McCracken, "Blackstone Unit Agrees to Purchase Birds Eye," *The Wall Street Journal* (Nov. 20, 2009); P. Lattman, "In Today's LBO Arena, Much Sweat, More Equity," *The Wall Street Journal* (Oct. 9, 2009).
[68] *See* Ernst & Young, *supra.*

[69] Dealscape, "Deal Economy 2010: No Bankruptcy Slowdown" (Nov. 18, 2009).
[70] "Bankruptcy Filings Surge," *The Chicago Tribune* (Nov. 27, 2009).
[71] Based on original poison pill adoptions through November 30, 2009, available at https://www.sharkrepellent.net/request?an=dt.runVolume&rnd=215447&pf=pf.
[72] RiskMetrics Group, U.S. Corporate Governance Policy 2010 Updates (Nov. 19, 2009), pp. 6-7.
[73] *Id*. RiskMetrics will take into account additional factors, including the date of the pill's adoption relative to the next shareholder meeting, the disclosed rationale for the pill, the company's governance structure and its track record of accountability.
[74] *Id*. at p. 7.
[75] RiskMetrics expects poison pills to have the following attributes: (1) 20 percent or higher flip-in or flip-over; (2) a term of no more than three years; (3) no dead-hand, slow-hand, no-hand or similar features; and (4) a shareholder redemption feature whereby if the board refuses to redeem the pill 90 days after an offer is announced, holders of 10 percent of the shares may call a special meeting or seek a written consent to vote on rescinding the poison pill.
[76] In a recent Delaware case, plaintiffs argued that a poison pill's language dealing with derivatives was so indefinite that there was no objective way to determine how the plan operated or when the rights would be triggered. In a ruling from the bench, the judge denied plaintiff's motion for injunctive relief, concluding only that the language was not "fatally vague" on its face and that factual evidence or expert testimony would be needed regarding how investors in the real world would react to the language. The parties settled before trial. *In re Atmel Corp. Shareholders Litig.*, C.A. No. 4161-CC (Del. Ch. May 19, 2009).
[77] The regulations under Section 382 of the Code are complex, but in general, an "ownership change" can occur if a stockholder owning at least five percent of the outstanding common stock increases its stake to more than 50 percentage points higher than the lowest percentage of the company's outstanding common stock it held within the prior three-year period.
[78] RiskMetrics Group, U.S. Corporate Governance Policy 2010 Updates (Nov. 19, 2009), pp. 16-17. In reviewing NOL poison pills, RiskMetrics will take into account the value of the NOLs, the ownership threshold, the term, whether it contains protection mechanisms and the company's existing governance structure and responsiveness to shareholders
[79] RiskMetrics Group, 2009 Proxy Season Scorecard (Results as of December 1, 2009).
[80] Georgeson, *supra*, at p. 42.
[81] Gregory T. Carrott, "The Case For and Against Staggered Boards," *Directorship* (Sept. 22, 2009), available at http://www.directorship.com/against-staggered-boards/.
[82] S. 1074 bans public companies from having a classified board. The Draft Dodd Bill permits public companies to have classified boards, but only with shareholder approval or ratification.
[83] RiskMetrics Group, 2009 Proxy Season Scorecard (Results as of December 1, 2009).
[84] *Id*.
[85] Rule 14a-8 under the Securities Exchange Act allows companies to exclude shareholder proposals if the company has already substantially implemented the proposal.
[86] Rule 14a-8 under the Securities Exchange Act allows companies to exclude a shareholder proposal if the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting.
[87] RiskMetrics will recommend that shareholders vote against, or withhold votes from, all nominees of the board of directors if the board failed to act on a shareholder proposal that received approval of the majority of shares cast for the previous two consecutive years. RiskMetrics Group, U.S. Proxy Voting Guidelines Concise Summary (Jan. 15, 2009), p. 3.
[88] The advance notice bylaw requires a shareholder to provide the company with advance notice (such as 60 to 90 days) of any shareholder business or director nominations that the shareholder wants to address at a shareholder meeting. Advance notice bylaws typically require a shareholder to provide the company with information on the shareholder proposal, director nominees (if any) and beneficial ownership.
[89] *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, 2008 WL 660556 (Del Ch. March 13, 2008), aff'd, CA No. 3447 (Del. Supr. Ct. May 13, 2008); *Levitt Corp. v. Office Depot, Inc.*, C.A. No. 3622-VCN (April 14, 2008).

[90] To address some of the issues raised by these cases, the advance notice bylaw provision should: (i) clearly apply to any shareholder proposal, regardless of whether the shareholder is bringing the proposal under Rule 14a-8; (ii) set a deadline for notice of shareholder proposals that is in reference to the annual meeting date, rather than the mailing date of the proxy materials (which is a Rule 14a-8 concept) and is a reasonable period of time prior to the annual meeting; (iii) specify the information required in the notice, rather than incorporate the requirements of the federal securities laws; and (iv) explicitly address shareholder nominations for directors, as well as other business proposed by shareholders.
[91] *See* Complaint, *TRT Holdings, Inc. v. Gaylord Entm't Co*., C.A. No. 4320-VCL (Del. Ch. Jan. 29, 2009). This case settled out of court.
[92] *See* the Draft Dodd Bill, S. 1074 and H.R. 2861.
[93] Spencer Stuart, *supra*, at p. 7.
[94] Corporate Board Member and PricewaterhouseCoopers, "What Directors Think 2009 Annual Board of Directors Survey," pp. 4, 8, available at http://www.pwc.com/en_US/us/corporate-governance/assets/what-directors-think-2009-report.pdf.
[95] SEC Division of Corporation Finance Legal Bulletin 14E (Oct. 27, 2009).
[96] The SEC previously allowed companies to exclude these proposals from their proxy statements, based on the argument that they relate to the termination, hiring or promotion of employees and, therefore, involve the company's ordinary business operations and could be excluded pursuant to Rule 14a-8(i)(7) under the Securities Exchange Act.
[97] D. Fitzpatrick, "BofA's Lewis May Consider Postponing Retirement," *The Wall Street Journal* (Nov. 21-22, 2009), p. B3.
[98] S. A. Miles and N. Bennett, "How the SEC Just Changed Succession Planning: Part 1," Forbes.com (Nov. 17, 2009), available at http://www.forbes.com/2009/11/17/succession-planning-sec-leadership-ceonetwork-search.html.
[99] RiskMetrics Group, 2009 Proxy Season Scorecard (Results as of December 1, 2009).
[100] SEC Division of Corporation Finance Legal Bulletin 14E (Oct. 27, 2009).
[101] Georgeson, *supra*, at p. 17.
[102] Spencer Stuart, *supra*.
[103] *Id*. In communicating with shareholders, management and directors should be mindful of their obligations under Regulation FD, which prohibits the selective disclosure of material nonpublic information.
[104] Speech by SEC Chairman Mary Schapiro: Address to the Practicing Law Institute's 41st Annual Institute on Securities Regulation, (Nov. 4, 2009).
[105] R. Daines, I. Gow and D. Larcker, "Rating the Raters: Are Governance Ratings Any Good?" Stanford Univ. Law School and Graduate School of Business, The Rock Center for Corporate Governance, available at http://www.chamberpost.com/files/Draft_of_Governance_Ratings.pdf. The study shows little or no correlation between governance ratings and a company's future financial performance (as measured by return on assets and stock price performance), the avoidance of accounting restatements or the avoidance of shareholder litigation. In fact, with respect to RiskMetrics, the data showed that firms given high governance ratings have more class action lawsuits, lower return on assets and abnormally bad stock price performance. *Id*. at p. 9.
[106] S. Choi, J. Fisch and M. Kahan, "Director Elections and the Role of Proxy Advisors," (Aug. 11, 2008) U. of Penn, Inst. For Law & Econ. Research Paper No. 08-18, available at SSRN: http://ssrn.com/abstract=1225963.