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STRAUSS HAUER & FELD LLP

Corporate Alert

TOP 10 TOPICS FOR DIRECTORS IN 2011

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With the economy sputtering, the balance of power in Washington shifting and sweeping financial and health care reforms on the way, directors will have many new issues to address in the coming year. Here is our list of hot topics for the boardroom in 2011:

1. Set appropriate executive compensation in the midst of increased regulatory and shareholder scrutiny.

2. Oversee enterprise-wide risk management, including all facets of the company's risk profile and crisis response plans.

3. Oversee the development of short-term and long-term strategy in an increasingly interdependent world economy.

4. Monitor challenges to the new SEC proxy access rules, which give certain shareholders the right to have director nominees included in the company's proxy materials, and prepare for proxy access if the rules are upheld.

5. Review existing board members' qualifications and ensure appropriate board composition.

6. Cultivate shareholder relations as investors push for more board transparency and accountability.

7. Consider M&A opportunities as the capital markets continue to rebound.

8. Review and revise, if appropriate, takeover defenses in response to recent judicial decisions and the rise in M&A activity.

9. Ensure that an effective succession plan is in place.

10. Monitor legislative developments and prepare for more government regulation.

DISCUSSION

1. Executive Compensation

Directors listed executive compensation as their number one concern in a recent survey,[1] and for good reason. While always a hot button with activist shareholders, there will be increased focus on pay practices in 2011 due to several measures in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"):

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- *Say-on-pay*. Beginning next year, shareholders of all public companies will have a vote on their company's executive compensation practices.[2] Even though the vote is nonbinding, boards and management will obviously want to avoid the embarrassment of a high negative vote.[3] Consequently, boards should take a close look at the appropriateness of their pay practices and proactively address any problem areas. Because shareholder focus on compensation disclosures will be keen during this inaugural year of mandatory say-on-pay, boards should also devote extra attention to the 2011 proxy statement. The company's message should not get lost in the voluminous compensation disclosures now required in proxy statements. Companies, if they have not already done so, should consider adding an executive summary to their Compensation Discussion and Analysis section that highlights the main compensation decisions of the last year and clearly ties them to the company's performance and objectives.

  In addition to the say-on-pay vote, companies must also give shareholders a vote in 2011 on whether the say-on-pay vote should occur every one, two or three years. In determining which choice to recommend to shareholders, boards should not automatically assume that a triennial vote is the best option. Instead, the board should carefully evaluate the company's current shareholder base and investor relations history, any expressed preferences of major shareholders and proxy advisory firms,[4] the recommendations being made by peer companies and whether any compensation committee members have recently received high negative or withhold votes.[5] Boards should also consider whether to implement the frequency vote approved by a plurality of the shareholder votes that are cast, even if it is not the board's recommended choice. Companies that do so will be able to exclude from future proxy statements, as substantially implemented, any shareholder proposals submitted under Rule 14a-8 that relate to say-on-pay or the frequency of say-on-pay. [6]

  New SEC rules also require companies to give shareholders a nonbinding vote on golden parachute arrangements in connection with any proxy statement seeking shareholder approval for a merger or similar transaction, unless the golden parachute arrangements were subject to a prior say-on-pay vote.[7] Consequently, boards also need to determine whether to include these golden parachute arrangements in the pay packages subject to the say-on-pay vote. Because this exception will be available only if lengthy additional disclosure is included in the proxy statement, we suspect many companies will decide to forgo this disclosure in the annual proxy statement and, instead, wait until shareholder approval is sought for a particular merger. Shareholders are less likely to be concerned about management's payout in connection with a specific transaction if the merger consideration is sufficiently attractive to shareholders.

- *Pay for performance and pay disparity disclosures coming soon*. The Dodd-Frank Act calls for companies to disclose in their annual proxy statements the relationship between executive compensation and the company's financial performance, as well as the ratio of the CEO's annual total compensation to the median annual total compensation of all other employees. The SEC intends to propose rules implementing these provisions during the summer of 2011. Although the rules will not likely be in effect until the 2012 proxy season, companies would be wise to begin laying the groundwork in this year's proxy statement by showing a strong link between pay practices and performance. Companies should also begin thinking about how to explain the pay disparity between the CEO and employees, particularly in relation to peer companies. A company with a high pay disparity ratio relative to its peers, for example, may be able to cite various distinguishing factors, such as the fact that it employs a significant number of minimum wage employees while many of its competitors outsource such low-paying positions.

- *Compensation Committee Independence and Authority*. The Dodd-Frank Act calls for the SEC and stock exchanges to adopt rules augmenting the independence and power of compensation committees. The rules must require that compensation committees have the authority to retain or obtain the advice of an advisor, and committees must consider certain factors that could affect the advisor's independence. In addition, each member of the compensation committee must be "independent," taking into account the source of compensation of the director (in addition to the amount) and whether the director is affiliated with the company. As such, a director could potentially be disqualified from serving on the compensation committee if the director beneficially owns a significant amount of the company's securities.[8] The SEC plans to issue proposed rules implementing these compensation committee requirements before the end of 2010 and adopt final rules by the middle of next year.

- *Clawbacks*. The Dodd-Frank Act calls for the SEC and stock exchanges to implement rules requiring companies to develop and disclose clawback policies for the recovery of incentive-based compensation granted to any current or former executive officer during the three-year period preceding an accounting restatement that is based on erroneous data corrected in the restatement. The language in the statute is broader than the clawback provision in the Sarbanes-Oxley Act, which applies only to the CEO and CFO, has only a one-year look-back and requires misconduct. The SEC expects to propose rules during the summer of 2011 implementing this provision, and the new rules will likely be in place before the start of the 2012 proxy season. Consequently, all boards will need to adopt or revise company clawback policies during 2011.

Although most of the focus in 2011 will be on executive compensation, directors may also want to give some consideration to their own compensation practices. Recent surveys of director compensation reveal that, while the amount of annual director compensation has remained fairly constant in recent years,[9] the components of compensation are shifting at many companies. Most notably, over the past few years companies have been trending away from paying board meeting fees to directors, with only 41 percent of companies surveyed paying such fees this past year, down from 62 percent in 2005.[10] Also, more companies are issuing restricted stock rather than granting stock options to directors. In 2010, stock awards accounted for 43 percent of director compensation, while option grants accounted for only 14 percent.[11]

2. Risk Management

Risk management took center stage in most boardrooms in the wake of the financial crisis and will continue to be a high priority for directors in 2011. While the financial meltdown awakened companies to a host of risks that they never even knew they had, an increasingly interconnected world economy continues to spawn newer and more-complex risks that challenge even the best-managed companies. In this environment, it is not surprising that shareholders and regulators are demanding greater transparency about risk management.

2010 was the first year companies had to comply with new SEC rules requiring companies to describe in their annual proxy statements the board's role in risk oversight, as well as the relationship between a company's compensation policies and risk-taking by employees when those risks are likely to materially affect the company. Surveys of these disclosures show that boards carry out their risk oversight responsibilities in a wide variety of ways, reflecting the fact that this critical task must be tailored to the particular company and the risks it faces.[12]

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, including operational, financial, strategic, compliance and reputational risks. In recent years, many companies have turned to an enterprise-wide, top-down approach to risk management that addresses all of a company's risks under one umbrella, in contrast to the more traditional "silo" approach, in which each operating function or division tackled risk independently.

In our 2010 edition of Top 10 Topics for Directors (available here), we discuss in detail the board's role in overseeing risk management, as well as some best practices that boards should consider in fulfilling their oversight function. We mention that a few companies, primarily in the financial and insurance sectors, have established separate risk committees. The Dodd-Frank Act will extend this practice to large bank holding companies and certain non-bank financial companies.[13] The legislation does not, however, require all public companies to have separate risk committees, and we expect most companies to continue to use a combination of existing board committees and the board as a whole to oversee risk management.[14]

In addition to overseeing risk management in general, boards should also make sure that their company's crisis management plan is up to date. High-profile crises in the past year, including the Gulf Oil spill and product recalls by some automakers, highlight the need for companies to have well thought-out response plans and for the board to be proactively involved in the response process.

3. Strategic Planning Challenges in 2011

One of the board of directors' most important functions is to oversee the development and implementation of corporate strategy. Certainly this task has become more daunting as companies rethink their strategies in light of the unprecedented events of the past few years. Virtually all companies are grappling to get a handle on what the "new normal" will be, as the turmoil from the financial crisis subsides and the economy slowly pulls out of the Great Recession. Among other things, companies will have to gauge whether there has been a permanent change in the spending habits of the American consumer, who had accounted for 70 percent of U.S. gross domestic product prior to the recession. Other factors that are likely to be in the mix for quite some time include tighter credit standards and lower leverage, increased government regulation, the ballooning federal deficit, federal monetary policy, increased international cooperation in setting economic and monetary policies and the growing strength of China and other emerging markets.

While management has the primary responsibility for developing corporate strategy, it is 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. In working through this process, it will be impossible for the board to make informed decisions without a full appreciation of the risks involved.

4. Proxy Access

The SEC has stayed the effectiveness of its recently adopted proxy access rules during the pendency of a lawsuit challenging the validity of the rules. The new rules would allow a shareholder (or group of shareholders) who owns at least 3 percent of the voting stock of a company and who has held the shares continually for at least three years to use management's proxy materials for the nomination of up to 25 percent of the company's board of directors, provided the shareholder is not seeking a change in control of the company.

The lawsuit, which was filed by Business Roundtable and the U.S. Chamber of Commerce, seeks to overturn the rules by arguing, among other things, that the rules are "arbitrary and capricious" in their treatment of state law and that the SEC failed to properly assess the costs of proxy access or the effects on "efficiency, competition and capital formation," as required by law. The parties are seeking expedited review, and a decision is likely to be rendered by late spring or early summer 2011.

Although the proxy access rules will not be in effect for the bulk of the 2011 proxy season, companies nevertheless will need to monitor the judicial challenge and prepare well in advance of the 2012 proxy season if the rules are upheld. Even if the court were to find deficiencies in the SEC's rule-making process, we would expect the SEC to correct the deficiencies and implement new proxy access rules as quickly as possible.

Some action items that boards will need to consider if the proxy access rules are upheld include—

- *Advance Notice Bylaws*. Virtually all companies will need to amend their advance notice bylaws to address proxy access. The new rules do not appear to preempt state law requirements for the nomination of directors, and under the laws of many states, including Delaware, a stockholder's right to nominate directors can be constrained by reasonable bylaw restrictions. Consequently, companies will need to decide the extent to which they wish to have the same or different bylaw requirements for proxy access nominations and nominations involving traditional proxy contests. Some areas where the proxy access rules are likely to diverge from a company's current bylaws include the "window" period during which shareholders must give advance notice of nominations and the information that shareholders must include in the notice. There are a multitude of factors that companies will need to consider when making these decisions, and companies would be wise not to delay this process beyond the summer of 2011.

- *Director Qualifications*. The SEC made clear in the adopting release that if a shareholder nominee does not meet director qualifications set forth in the company's governing documents, the company still must include the nominee in its proxy materials, although the company would not have to seat the director if elected. Consequently, companies should consider moving key director qualifications (such as age, minimum stock ownership and limits on number of other directorships) from their corporate governance guidelines to their bylaws.

- *Shareholder Relations*. Fostering good shareholder relations will be increasingly important with proxy access. Shareholders are less likely to demand representation on the board of directors if a company's board and management listen and react to shareholder concerns and suggestions.

- *Shareholder Proposals*. Even if boards do not feel especially vulnerable to a challenge under the proxy access rules, which have a 3 percent ownership threshold and a three-year holding period requirement, they may find themselves dealing with shareholder proposals that would provide shareholders with more lenient methods of nominating directors for inclusion in company proxy materials. In connection with the proxy access rules, the SEC also revised a rule that allowed companies to exclude from their proxy materials shareholder proposals relating to the nomination or election of directors. Under the amended rule, which also has been stayed pending resolution of the lawsuit challenging proxy access, a company must include in its proxy materials a shareholder proposal seeking to amend the company's governing documents concerning director nomination procedures so long as the proposal does not conflict with SEC proxy rules or applicable law. Consequently, companies will not be able to exclude from their proxy materials shareholder-proposed bylaw amendments that would give shareholders the right to have their nominees included in the company's proxy materials upon satisfaction of lower (or no) stock ownership thresholds and/or shorter holding periods.

- *Size of Board*. Boards that may be particularly susceptible to proxy access may wish to consider adjusting the size of the board to mitigate the impact that proxy access nominees would have, if elected. The rules permit nominating shareholders to nominate up to 25 percent of the board. If this does not result in a whole number, the maximum number of directors that could be nominated will be rounded down. For example, if the company's board consists of 12, 13, 14 or 15 directors, in each case the company would only be required to include three shareholder nominees in its proxy statement.

5. Board Composition

Boards need to make sure that they have a proper mix of experience and skills among directors to address their company's business needs and challenges. Not only are there increased disclosure requirements about director qualifications, but any perceived weakness in a director's credentials could open the door for activist shareholders, especially with proxy access looming.

2010 was the first year that companies were required to discuss in their proxy statements the particular experience, qualifications and attributes that qualify incumbent directors and nominees to serve on the board. Companies also had to begin disclosing whether and how the nominating committee or board considers diversity in identifying director nominees. The SEC did not define "diversity" and, instead, noted that diversity may include a variety of skills, backgrounds and other attributes that contribute to board heterogeneity. A review of 2010 proxy statements shows that many companies did not take advantage of the new disclosure requirements to fully explain why their directors are a good fit for the company and, instead, provided only bare-bones or generic discussion of their directors' qualifications. The nominating committee or board should revisit these disclosures before the 2011 proxy season to make sure they highlight the strengths and talents that each director brings to the board.

In evaluating the board's composition, the nominating committee or board may find that new skills are needed as a result of the financial crisis and the transformation that many companies have subsequently undergone. 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. In addition, multinational companies may find that they would benefit from a more internationally diverse board. The nominating committee should also carefully evaluate whether there are any directors with poor attendance records or independence issues that could spur a vote "no" campaign or a proxy access nomination. Activist labor and pension funds and other likely users of proxy access reportedly have already begun to create pools of potential director candidates, and some pension funds have already announced that they plan to target diversity in the 2011 proxy season.

6. Cultivating Shareholder Relations

With shareholders, regulators and legislators 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 2011, with shareholders now having a say-on-pay and with proxy access looming on the horizon for 2012. Some steps companies need to be taking include—

- *Know your shareholders*. In light of increasing shareholder activism, companies need to understand the breakdown of their shareholder base. With proxy access in the wings, this includes identifying not just large shareholders, but also any smaller shareholders who may be likely to pool their share holdings to reach the 3 percent threshold required to nominate directors.

- *Engage your shareholders*. Reaching out to significant shareholders not only is a good way to find out what they want, but also helps to build credibility and stronger relationships. In a recent survey of S&P 500 companies, more than 80 percent of respondents reported that their management or boards had reached out to shareholders to solicit their input.[15] Over half 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 a variety of topics ranging from sustainability and social responsibility to business strategy and a change in management. [16]

- *Send a consistent message*. While it is important to be receptive to shareholder concerns, companies also need to make sure that everyone in their organization is on the same page when communicating with shareholders. Sending a strong, consistent message not only proves to shareholders that the company has thoughtfully discussed and considered the issues, but also brings credibility to both the company and its spokespersons.

- *Watch what you say*. Those charged with communicating with shareholders must understand the legal limits on what they can talk about. Regulation FD prohibits the selective disclosure of material nonpublic information to certain market participants and to shareholders who are likely to trade. After a four-year lull, the SEC has brought three Regulation FD enforcement actions in a little over a year, the most recent one involving allegations that the CEO and CFO of Office Depot improperly signaled to analysts in one-on-one conversations that the company would not meet future earnings expectations. [17]

  Company spokespersons must be mindful of what they can say not only in conversations and meetings with analysts and investors, but also in other settings—including social media such as blogs, Twitter and Facebook—that many companies are now incorporating into their formal disclosure practices. In addition to Regulation FD limitations, certain types of corporate disclosures must be accompanied by specific cautionary language,[18] and to take advantage of a safe harbor for forward-looking statements, a communication must provide sufficient reference to factors that could cause actual results to differ materially. An SEC official recently cautioned companies about using Twitter to convey certain corporate information because a tweet is limited to just 140 characters. [19]

- *Determine director involvement*. Companies need to determine whether, and to what extent, directors should be authorized to communicate directly with shareholders on the company's behalf. There is growing pressure on directors to talk directly with significant shareholders, particularly regarding matters, such as executive compensation and corporate governance, where shareholder communications with management could be awkward. The SEC has also sought to encourage more dialogue between directors and shareholders,[20] and it recently issued interpretive guidance that clarifies that Regulation FD should not be a barrier to director-shareholder communications. The guidance suggests steps companies can take to address Regulation FD compliance concerns, such as preclearing discussion topics with the shareholder, having company counsel attend the meeting or obtaining a confidentiality agreement from the shareholder. [21]

  While there may be increasing pressure on direct communications by directors with shareholders, our survey of published corporate governance guidelines and disclosure policies at the S&P 100 companies shows that most companies carefully limit director interaction with shareholders. Of the 69 companies that discussed the subject, less than three percent stated that directors were available generally to speak with shareholders. Sixty-three percent affirmatively stated that management spoke for the company and either did not authorize directors to speak with shareholders or generally only allowed directors to speak at management's request.[22] Twenty-nine percent authorized the lead or presiding director to communicate directly with shareholders, but typically only with major shareholders. If a company does permit its directors to communicate directly with shareholders, appropriate Regulation FD safeguards should be put in place, and the authorized directors and management should be delivering a coordinated and consistent message.

7. The Return of M&A

M&A activity has been picking up steam during 2010 after an abysmal 2009, and all indications are that next year will be an even stronger year for deal-making. The third quarter of 2010 was the busiest in two years.[23] For the first nine months of 2010, worldwide announced deals totaled $1.42 trillion, up 25 percent from the same period in 2009.[24] This puts 2010 on pace to surpass the $1.76 trillion announced in all of 2009,[25] although still well below the $4.28 trillion hit in 2007 at the peak of the M&A boom.

Many companies that built up significant cash reserves to survive the recession are now looking for acquisitions as part of their growth strategy. Bloomberg estimates that the world's 1,000 largest nonfinancial companies are sitting on $2.87 trillion in cash and cash equivalents.[26] Record low interest rates and easing of tight credit standards are also fueling the pickup in M&A activity. Private equity firms are also back in the market, unloading portfolio companies they were forced to hold during the financial crisis and picking up attractive targets through leveraged buyouts. For the first nine months of 2010, private equity buyouts totaled $151.3 billion, up 94 percent from the same period last year, but still just one-tenth of M&A activity overall. [27]

The technology, natural resources and financial services sectors are all expected to be hotbeds of activity in 2011.[28] Cross-border M&A will also be strong. With near stagnant growth in the United States and Europe, many Western companies are seeking opportunities to better position their businesses in emerging markets. Asian companies, on the other hand, have been attracted to the West by relatively lower valuations and favorable currency exchange rates. Government-sponsored Chinese enterprises are also expanding globally in their hunt for natural resources.

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, both domestically and internationally, that may not be available organically. While we will not see a return to anywhere near the giddy highs of 2007, companies should nevertheless be poised to seize opportunities as the markets continue to improve. Companies should also be keeping an eye on what's happening on the M&A front with respect to their competitors and suppliers, where ownership changes can have a significant impact on business operations and the competitive landscape.

8. 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. During 2010, hostile deals have been on the rise,[29] and the number of proxy contests hit 100 for the fifth year in a row.[30] Directors need to carefully assess the adequacy of their company's takeover defenses, particularly since, in recent years, many companies have been forced to dismantle some of their defenses in response to shareholder activism. Three defenses that are receiving a lot of attention are poison pills, classified boards and denial of shareholders' right to call special meetings.

Poison Pill. The use of poison pills as a takeover defense has been falling out of favor for several years, due in large part to shareholder opposition and ISS' strong recommendation against poison pills. During 2010, the number of companies with poison pills dropped below 1,000 for the first time in 20 years.[31] We highlight below some considerations that boards should take into account regarding poison pills.

- *Process is Important*. Delaware courts addressed the validity of poison pills on several occasions in 2010.[32] In each instance in which the court upheld the board's use of the pill, the court relied in part on the strength of the board's decision-making process in adopting the rights plan. These decisions underscore the importance of building a record that establishes the directors' independence, good faith and reasonableness in approving a rights plan. Among other things, the record should show that the independent directors engaged in thorough deliberations and were aided by competent and experienced financial and legal advisors.

- *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 ISS,[33] but, instead, can ensure that the poison pill is sufficiently potent to adequately protect the company.

- *Derivative Positions/Acting in Concert*. As investors have significantly increased their use of derivative, swap and other similar 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 because including derivative positions in the calculation of beneficial ownership under a poison pill has not been addressed by the Delaware courts.[34] 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.

  Most rights plans include in the definition of "beneficial ownership" a "group" concept that is based on the definition of a group under federal securities laws. In an effort to capture hedge fund "wolf packs" and other situations where activist investors communicate with each other or engage in coordinated activities but do not form a group, some companies have expanded the definition of beneficial ownership in their rights plans to include situations where shareholders are "acting in concert" or working cooperatively. This language, which has not been tested in the Delaware courts, may be susceptible to arguments that it is too vague or that it impermissibly impinges on the ability of shareholders to communicate regarding a proxy contest. In one of the 2010 Delaware cases, the court upheld a traditional formulation of the term "group" in Barnes & Noble's rights plan. The definition had initially also included some cooperation language, but the Barnes & Noble board dropped this language after a request for clarification by a hostile hedge fund. [35]

- *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), which can be lost if there is an "ownership change" of the company. An ownership change can occur when shareholders owning at least 5 percent of a company's stock trade more than 50 percent of the outstanding stock during a three-year period. Questions regarding the validity of using a poison pill to protect a valuable corporate asset rather than fending off a takeover were laid to rest in a 2010 decision by the Delaware Supreme Court, which sanctioned the use of a poison pill with a 4.99 percent triggering threshold to protect a company's NOLs.[36] In reaching its decision, however, the court emphasized that its determination was predicated on the specific facts and circumstances of the case and "should not be construed as generally approving the reasonableness of a 4.99 percent trigger in the rights plan of a corporation with or without NOLs."[37] Therefore, NOL pills will continue to be scrutinized by the courts. Also, another Delaware court has cautioned that the definition of beneficial ownership in an NOL pill may need to be more narrowly tailored in light of the specific tax concerns the pill is designed to address.[38] ISS does give companies some leeway regarding NOL poison pills by reviewing them on a case-by-case basis, provided the term is less than three years. [39]

Classified Boards. ISS and several other proxy advisory firms view the traditional takeover defense of a classified board unfavorably and almost always recommend voting for a proposal to declassify a company's board, so all directors are elected annually. During 2010, activist shareholders placed 60 proposals to repeal classified boards on company ballots and received strong shareholder support, with an average of 58.7 percent of votes cast supporting board declassification.[40] Also, in response to pressure from activists, management submitted 45 declassification proposals to shareholders in 2010.[41] Largely due to such activism, the number of companies with staggered boards has decreased significantly over the past few years, with only 28 percent of companies in the S&P 500 retaining a classified board.[42]

Companies with classified boards should think carefully before succumbing to shareholder pressures to declassify the board. A classified board provides a company with additional leverage against a potential hostile acquirer because the acquirer is unable to gain control of a majority of the board at a single annual meeting.[43] A classified board also strengthens the deterrent effect of a poison pill because an acquirer 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. Activists are continuing to pressure companies to give shareholders the 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. In 2010, 45 shareholder proposals seeking a shareholder right to call special meetings made it onto company ballots, receiving average support of 43 percent.[44] 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. 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. According to Georgeson, 16 companies successfully used this approach in 2010. [45]

Majority Voting. In addition to shareholder proposals relating to the topics discussed above, companies can expect to see an increase this proxy season in shareholder proposals seeking a majority voting standard for the election of directors. Activist investors have expressed renewed interest in pushing companies to adopt majority voting after a majority measure was dropped from the Dodd-Frank Act. Although only 30 majority voting shareholder proposals made it onto company ballots in 2010, they were supported by an average of 57.6 percent of votes cast.[46] Because nearly 70 percent of S&P 500 companies have already adopted some form of majority voting, activists are expected to target more mid-size and smaller companies next year. One union has already announced that it intends to file about 100 majority voting shareholder proposals in 2011, focusing on those S&P 500 companies that have not yet adopted this standard, while an activist pension fund has sent letters promoting majority voting to all companies in the Russell 3000 that do not have majority voting procedures. [47]

9. Succession Planning

Replacing a CEO, whether due to a planned retirement, forced resignation or sudden departure, is one of the most challenging responsibilities that boards may face, but having an effective succession plan in place can ease the transition and instill confidence in shareholders and the marketplace. Recent studies show that boards are increasingly recognizing the importance of succession planning, which can often be an uncomfortable topic to address with current management. The boards of almost all S&P 500 companies now discuss CEO succession planning at least once a year, and over half of them discuss CEO succession at least twice a year.[48] Eighty-six percent of S&P 500 boards have adopted an emergency succession plan, and 72 percent have a long-term plan in place. [49]

Boards are often forced unexpectedly to deal with a CEO's departure. In the first half of 2010, 41 S&P 500 companies experienced a change in their CEO.[50] When dealing with such a transition, the strength of a company's succession plan—or lack of one—is often obvious. A company that is prepared can calm the markets by immediately announcing a successor who is well-qualified and able to lead the company effectively through the transition. Other companies may search months before finding a capable successor, or, due to time pressures, settle for someone who is not the best possible choice.

A recent change in SEC policy now makes it easier for shareholder proposals relating to succession planning to make it onto company ballots.[51] In 2010, activists filed shareholder proposals calling on company boards to adopt and disclose annually to shareholders a detailed succession planning policy containing certain specific best practices. These best practices include requiring the board to (1) review the plan annually, (2) develop criteria for the CEO position that reflects the company's business strategy, (3) identify and develop internal candidates and (4) have in place both a non-emergency, as well as an emergency, succession plan.

Although none of these shareholder proposals passed in the 2010 proxy season,[52] shareholder support is likely to grow if companies do not address the issue.

Although shareholders are often focused on CEO succession, effective succession planning extends beyond the CEO and includes other key leadership positions as well. Boards need to identify, and develop plans for filling, those positions that are critical to the organization, which may include not only the more obvious C-suite executives, but also account managers, line supervisors or others whose immediate vacancy could significantly disrupt business operations.

In our 2010 edition of Top 10 Topics for Directors (available here), we discuss actions the board should be taking with respect to succession planning. Boards often push succession planning to the back burner while they address more urgent day-to-day obligations. Rather than reacting to a shareholder proposal, or, worse yet, a corporate scandal, health issue or poor company performance that signals the need for a new CEO, boards need to devote sufficient time and attention to establishing a credible succession plan, so that the company has viable candidates ready to step up and serve in key management positions if given the opportunity.

10. Monitoring Legislative and Regulatory Developments

Compliance fatigue is setting in at many companies. Constantly changing and overlapping legislative and regulatory requirements are weighing down corporations and usurping more and more board time. It is a telling sign when directors list compliance as one of their top concerns, and 88 percent of directors surveyed expect government regulation and oversight of business to increase next year.[53] The directors' concerns are on the mark:

- Weighing in at more than 2,000 pages, the Dodd-Frank Act leaves many of the details for the overhaul of the financial system to additional rule-making.
- Health care reform is just beginning, with many of the reform measures to be implemented over the next three years, and most of the regulations yet to be drafted. How these regulations are written will impact the bottom line of all companies.
- With the Bush tax cuts scheduled to expire at year-end, the lame duck session of Congress is expected to take some sort of action; failing that, new tax legislation will be a top priority when Congress reconvenes in January.
- EPA regulations to curb carbon emissions across wide swaths of the economy are set to begin next year, although judicial challenges and likely Republican opposition in Congress may rein in the EPA.

These are just a few of the areas where companies will face new regulatory challenges in 2011. Companies can also expect to see an uptick in SEC investigations and enforcement actions as a result of new whistleblower incentives. The Dodd-Frank Act provides that a whistleblower providing original information to the SEC that leads to a successful enforcement action resulting in monetary sanctions exceeding $1 million can earn a reward of between 10 and 30 percent of the collected amount.[54]

In addressing compliance oversight responsibilities, boards should also take note of a recent change to federal sentencing guidelines. Companies that comply with the guidelines' requirements for an effective compliance program are eligible for a reduced sentence or may be able to avoid prosecution altogether. Under the amended guidelines, which went into effect in November 2010, a company's compliance program will still be viewed as "effective" notwithstanding high-level employees' involvement in the wrongdoing if, among other things, the compliance officer has express authority to communicate directly with the board or appropriate committee, such as the audit committee. This authority must include the ability to communicate promptly with respect to actual or potential criminal conduct and at least annually regarding the implementation and effectiveness of the compliance program. In light of the amendments, all companies should be determining whether any changes are necessary to their chief compliance officer's role and to the audit committee charter to assure the compliance officer has appropriate access.

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[1] *Corporate Board Member*, Feeling the Heat – Results of The Corporate Board Member/FTI Consulting 2010 Legal Study (2010 Special Supplement).
[2] Companies will be required to include the say-on-pay and say-on-frequency votes in proxy statements for the first annual meeting occurring on or after January 21, 2011.
[3] Prior to 2010, no U.S. company had received a majority vote against a say-on-pay proposal voluntarily submitted by management or a say-on-pay proposal required at companies receiving TARP funds. During 2010, three companies (Motorola, Occidental Petroleum and Key Corp.) failed to receive majority support for management-sponsored say-on-pay proposals.
[4] ISS (Institutional Shareholder Services Inc.) will recommend that the say-on-pay vote be conducted annually rather than every two or three years. In ISS' view, an annual vote provides the most consistent and clear communication channel for shareholder concerns about companies' executive pay programs. ISS, U.S. Corporate Governance Policy 2011 Updates (Nov. 19, 2010), at 16.
[5] If a company has what ISS considers to be "problematic" pay practices, ISS will generally recommend a negative vote on management's say-on-pay proposal, but will recommend withholding votes from compensation committee members when a say-on-pay proposal is not on the ballot. Consequently, compensation committee members at companies with pay practices that are criticized by ISS will face a higher risk of negative votes (and not being reelected if the company has majority voting) in years in which say-on-pay is not on the ballot.
[6] This assumes that the SEC's proposed rules implementing say-on-pay and frequency of say-on-pay are adopted substantially as proposed. The proposed rules also require companies to disclose in the quarterly report for the period during which the frequency vote occurred (or in the Form 10-K if the vote occurred in the 4th quarter), their decision on how frequently the company will conduct say-on-pay votes in light of the results of the shareholder vote on frequency. SEC Release Nos. 33-9153; 34-63124, Shareholder Approval of Executive Compensation and Golden Parachute Compensation (October 18, 2010) at pp. 23-28.
[7] The shareholder vote on golden parachute arrangements will not be required until the SEC adopts final rules regarding the vote. The comment period on the SEC's proposed rules expired on November 18, 2010, and the SEC is expected to adopt final rules in the near future.
[8] The independence requirement in the Dodd-Frank Act closely tracks the independence standard imposed on audit committee members under the Sarbanes-Oxley Act. In implementing the audit committee standard, the SEC created a safe harbor that provides that a person will not be deemed to be in control of an issuer where the person is not an executive officer and does not own more than 10 percent of any voting securities of the company. It remains to be seen whether the SEC and the stock exchanges will adopt the same standards for compensation committee members.
[9] Hewitt Associates, 2010 Analysis of Outside Director Compensation (March 2010) Appendix F; *see also* Spencer Stuart, 2010 Spencer Stuart Board Index (2010) at 6.
[10] Spencer Stuart, *supra* at 6.
[11] Spencer Stuart, *supra* at 32.

[12] *See* Deloitte, "Risk Intelligent proxy disclosures: Transparency into board-level risk oversight" (2010); Akin Gump client alert, "The Board's Role in Risk Oversight: A Survey of Recent Proxy Statement Disclosures" (April 6, 2010), which is available here; Spencer Stuart, *supra* at 27.
[13] Section 165(h) of the Dodd-Frank Act requires the Board of Governors of the Federal Reserve Board to issue regulations requiring each bank holding company with more than $10 billion in assets, as well as each nonbank financial company supervised by the Board of Governors, to establish a risk committee that is composed of independent directors, including at least one "risk management expert."
[14] Only 4 percent of S&P 500 companies have stand-alone risk committees, according to the 2010 Spencer Stuart Board Index.
[15] Spencer Stuart, *supra* at 31.
[16] *Id*.
[17] *See* SEC press release, "SEC Charges Office Depot and Company Executives with Improper Disclosures to Analysts" (Oct. 21, 2010), available at http://www.sec.gov/news/press/2010/2010-202.htm
[18] For example, Rule 165 under the Securities Act of 1933 requires certain disclosure language in connection with a business combination in which securities are used, and Rule 14a-12 under the Securities Exchange Act of 1934 requires certain information accompanying communications in connection with proxy solicitations.
[19] *See* BNA, "Citing Disclosure Rules, SEC Official Cautions Firms' Use of Twitter Messages," 42 Securities Regulation and Law Report 1940 (October 2010).
[20] *See* remarks by SEC Chairman Mary Shapiro at the NACD Annual Corporate Governance Conference (Oct. 19, 2010).
[21] SEC Regulation FD Compliance and Disclosure Interpretation 101.11 (June 4, 2010).
[22] Of the 63 percent that stated that management spoke for the company, 32 percent either had no further discussion or stated that directors could speak with shareholders only at management's request. The other 31 percent stated that directors could communicate with various constituencies with the knowledge, and absent unusual circumstances, only at the request, of management.
[23] B. Foley & J. McCracken, "M&A Snaps Back as BNP, Intel Drive Busiest Quarter in 2 Years" (Sept. 28, 2010), available at http://www.bloomberg.com/news/2010-09-29/m-a-snaps-back-as-bhp-intel-drive-busiest-quarter-in-2-years.html.
[24] Mergermarket, M&A Round-up for Q1-Q3 2010 (Oct. 7, 2010).
[25] Bloomberg, *supra*.
[26] *Id.*
[27] Mergermarket, *supra*.
[28] Bloomberg, *supra*.
[29] According to Mergermarket, 37 unsolicited deals were announced in the first nine months of 2010, six more than in the same period in 2009. Mergermarket, *supra*.
[30] SharkRepellent.net, "Proxy Fight Trend Analysis 2001-Present" (Nov. 17, 2010). Once a dissident publicly discloses that it has delivered a formal notice to the company that it intends to solicit proxies from shareholders, it is considered a proxy fight in the SharkRepellent.net database.
[31] J. Laide, "The Number of Companies with Poison Pills Falls Below 1,000 for First Time in Twenty Years," SharkRepellent.net (April 1, 2010), available at https//www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20100401.html&Specific_Purpose_Poison_Pills&rnd=517067.
[32] *Versata Enterprises Inc. v. Selectica, Inc*., No. 193, 2010 (Del. Oct. 4, 2010); *Yucaipa American Alliance Fund II, L.P. v. Riggio,* C.A. No. 5465-VCS (Del. Ch. Aug. 11, 2010); *eBay Domestic Holdings, Inc. v. Newmark,* C.A. No. 3705-CC (Del. Ch. Sept. 9, 2010); *Selectica, Inc. v. Versata Enterprises, Inc.,* C.N. 4241-VCN (Del. Ch. Feb. 26, 2010), *aff'd*., *Versata Enterprises Inc*., *supra*.
[33] ISS 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.
[34] 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). Even if the language can be drafted clearly, there are various considerations—and challenges—when crafting the language so as to appropriately deter an intended beneficial owner while not unnecessarily penalizing a counterparty to a swap or other derivative instrument.
[35] Yucaipa, *supra* at pp. 49-50
[36] *Versata Enterprises, Inc. v. Selectica, Inc*., C.A. No. 193, 2010 (Del. Oct. 4, 2010).
[37] *Id*. at 52.
[38] *Yucaipa American Alliance Fund II, L.P. v. Riggio*, C.A. No. 5465-VCS (Del. Ch. Aug. 12, 2010), at fn. 244.
[39] ISS, U.S. Corporate Governance Policy 2011 Updates, *supra* at 10. ISS will vote against NOL poison pills if the term exceeds the shorter of three years and the exhaustion of the NOL. Otherwise, ISS will vote on a case-by-case basis, taking into account the value of the NOLs, the ownership threshold, whether the poison pill contains protection mechanisms and the company's existing governance structure and responsiveness to shareholders.
[40] ISS, 2010 U.S. Post Season Report (Nov. 12, 2010), at 16.
[41] Georgeson, *2010 Annual Corporate Governance Review*, available at http://www.georgeson.com/usa/download/acgr/acgr2010.pdf.
[42] Spencer Stuart, *supra* at 14.

[43] The Delaware Supreme Court recently rejected a hostile bidder's effort to circumvent the intended effect of a classified board by amending the target company's bylaws to accelerate its annual meeting by eight months. *Airgas, Inc. v. Air Products & Chemicals, Inc*., 2010 WL 4734305 (Del. Nov. 23, 2010). The bidder had won three seats on the target's nine-person staggered board at the target's September 15, 2010 annual meeting. At the annual meeting, shareholders also approved an amendment to the target's bylaws that would have effectively moved the 2011 annual meeting up to January 2011, thereby giving the bidder the opportunity to seize control of the target's board in a span of just four months. In striking down the amendment, the Delaware Supreme Court concluded that the language in the target's charter regarding the term of directors was ambiguous. The language provided that a director's term would expire "at the annual meeting of stockholders held in the third year following the year of election," rather than expressly stating that directors would serve three-year terms. After reviewing extrinsic evidence, however, the Delaware Supreme Court held that the type of language used in the target's charter nevertheless meant that directors would serve three-year terms and, therefore, the bylaw amendment impermissibly shortened the directors' terms by eight months.
[44] ISS, 2010 U.S. Post Season Report, *supra* at 16.
[45] Georgeson, *supra* at 6.
[46] ISS, 2010 U.S. Post Season Report, *supra* at pp. 16-17.
[47] *Id*. *See also* Council of Institutional Investors, "State, Local Funds Focus on Wide Range of Issues in 2011 Proxy Season" (Nov. 10, 2010).
[48] Spencer Stuart, *supra* at 30.
[49] *Id*.
[50] Spencer Stuart 2010 Quarter 1 and Quarter 2 S&P 500 CEO Turnover Research, available at http://content.spencerstuart.com/sswebsite/pdf/lib/Q1_2010_turnover_data.pdf and http://content.spencerstuart.com/sswebsite/pdf/lib/Q2_2010_turnover_spread_to_post_updated.pdf, respectively.
[51] Prior to its change in policy in October 2009, the SEC had allowed companies to exclude shareholder proposals related to a company's CEO succession planning policy under the ordinary business exception. *See* SEC Division of Corporation Finance Legal Bulletin 14E (Oct. 27, 2009).
[52] Shareholder proposals related to succession planning went to a vote at four S&P 1500 companies, with the following percentage of votes cast voting "for" the proposal: Bank of America Corporation – 39.8 percent; Comcast Corporation – 14.5 percent; Verizon Communications, Inc. – 31.3 percent; and Whole Foods Market, Inc. – 29.1 percent. Georgeson, *supra* at 33.
[53] *Corporate Board Member*, *supra*.
[54] The SEC has published proposed rules implementing the whistleblower provisions. The comment period on the proposed rules will expire on December 17, 2010, and final rules are expected to be adopted in early 2011. Note, however, that information provided to the SEC after July 21, 2010 may still be considered "original information" for purposes of the whistleblower incentives even if provided prior to the effective date of the final rules.

