Corporate Alert
TOP 10 TOPICS FOR DIRECTORS IN 2012

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With the European debt crisis threatening to tip the world economy into another recession and gridlock in Washington stalling much-needed government action on a variety of fronts, 2012 will be a challenging year for companies. Here is our list of hot topics for the boardroom in the coming year:

1. Oversee the development of corporate strategy in an increasingly interconnected and volatile world economy.
2. Oversee risk management, including the identification and assessment of new and emerging risks as companies expand their global footprint.
3. Set appropriate executive compensation now that shareholders have a say-on-pay and income inequality is drawing increasing media attention.
4. Monitor corporate political contributions during an election year as pressure mounts on companies to disclose their political spending practices.
5. Monitor the 2012 elections.
6. Ensure the company’s compliance programs are up-to-date as regulators step up anti-corruption enforcement efforts and whistleblowers can now earn huge bounties.
7. Ensure appropriate board composition to best enable the company to meet new challenges.
8. Assess impact of looming health care reform on the company’s benefit plans and cost structure.
9. Monitor developments in proxy access as shareholders can now submit proposals requiring companies to include shareholder director nominees on company ballots.
10. Ensure that an effective succession plan is in place.

1. Strategic Planning Challenges in 2012

Directors listed strategic planning as their number one concern in a recent survey, and for good reason. Figuring out where the company wants to go and how to get there certainly is not getting any easier. Companies increasingly find themselves buffeted by macroeconomic and geopolitical events over which they have no control. On the domestic front, companies face a sluggish economy, a ballooning federal deficit, gridlock in Washington, regulatory uncertainty and soaring health care costs. Internationally, sovereign debt concerns, slowing growth in China and other emerging markets and political instability in the Middle East are just a few of the clouds hanging over businesses.
While reading the tea leaves has never been easy, it is proving to be particularly challenging in the post-Great-Recession era. Among other things, there has been much speculation about whether the financial crisis has permanently altered the profligate spending habits of the American consumer, much as the Great Depression had a lasting impact on an entire generation of Americans. Despite some claims of a more frugal “new normal,” erratic U.S. consumer spending habits continue to befuddle analysts, so much so that one commentator has dubbed the current environment as the “new abnormal, in which no one knows anything.”\(^3\) Although the average American now shops for discounted private label brands at the grocery store, he continues to drink his $4.00 latte and wait in line to buy the latest smartphone.

While it may be difficult to discern whether Americans have permanently changed their views about spending, it is clear that external factors will continue to constrain consumer spending in America for quite some time. Lost housing wealth, flat or declining wages, high unemployment and tighter lending standards have left American consumers with fewer dollars to spend even if they wanted to.

With limited domestic opportunities, companies are increasingly turning their attention abroad, where a burgeoning middle class in China and other emerging markets is expected to fuel growth for years to come. The increasing focus on global operations may prove to be particularly challenging for some boards of directors, who may find that they would benefit from a more internationally diverse mix of directors.

Another new factor in the strategic planning equation is the explosion of Internet marketing and social media. Consumer access at the touch of a fingertip to product information, comparative pricing and customer reviews is rapidly changing how companies position their products. And growing customer expectations that companies engage with them through social media 24/7 are forcing companies to rethink their marketing strategies.

Many companies are also retooling their business strategies in light of the treasure trove of demographic data contained in the recently released 2010 census results. While the data show a “graying of America” as the baby boomer generation ages, they also show a more ethnically diverse population, as well as a birth rate close to replacement level that should help offset the impact of an aging population. Careful analysis of these demographic trends will be critical to companies as they assess strategic challenges and seek to identify and capitalize on new opportunities.

In the meantime, in light of all of the economic and political uncertainty, it is not surprising that companies continue to stockpile cash to ensure they have sufficient funds to weather another recession. Nonfinancial U.S. companies are presently sitting on a record $2 trillion in cash and other liquid assets. Ultimately, companies will need to make important strategic decisions about whether and when to deploy these funds.

One of the most important functions of the board of directors is oversight of the development and implementation of corporate strategy. 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. In light of the rapidly changing dynamics of the marketplace, this will be a process that management and boards will have to revisit often during the coming year.

2. Risk Management

Risk management goes hand in hand with strategic planning—it is impossible to make informed decisions about the company’s strategic direction without a full understanding of the risks involved. Risk management took center stage in boardrooms in the wake of the financial crisis and continues to be a hot topic for directors. As companies continue to expand their global footprint, they find that they are encountering new risks and uncertainties that need to be addressed.

While recent studies show that directors are now doing a better job of overseeing their company’s risk management processes relating to operational, financial and compliance risks, many boards are still lagging in their oversight of how their companies are addressing emerging risks.\(^3\) Indeed, most companies themselves are having a hard time identifying and monitoring newly developing risks. In one recent study, 62 percent of senior executives surveyed rated their
companies as only “moderately effective” or “ineffective” at integrating emerging risk information into ongoing business decisions, and half of the companies surveyed did not include information about newly developing risks in their strategic planning exercises. Emerging risks can include not only the occasional outlier, but also other higher-probability risks that can undercut key business assumptions and even threaten the enterprise. Accordingly, boards would be well-advised to inquire into their company’s processes for identifying, assessing and addressing emerging risks.

One risk that certainly should be on the radar screen at all companies is data security. Not surprisingly, directors recently identified data security as one of their top risk concerns, second only to operational risk. Yet, many companies are not doing enough to manage IT risks: in a recent survey, one in four companies with revenues up to $1 billion was not performing any kind of IT risk assessment, and 42 percent of surveyed companies said they can’t address specific parts of their IT audit plans because they don’t have the expertise or resources. In recognition of the dramatic rise in cyber attacks and data breaches, the SEC recently weighed in on the topic by issuing guidance regarding company disclosure obligations about cybersecurity risks and cyber incidents. In view of the potentially high costs of a cybersecurity attack, including negative publicity, reputational damage, remediation costs and loss of revenue and customers, all companies should be assessing their exposure to an attack and the adequacy of their disclosures regarding data security in their SEC filings.

Of course, risk management is not simply about risk mitigation. Proper enterprise risk management encompasses an assessment of a company’s upside, as well as downside, risks and thus helps inform the strategic planning process. As part of its oversight function, the board needs to be satisfied that the company’s risk appetite, i.e., the amount of risk the company is willing to accept in pursuit of stakeholder value, is appropriate for the company. In our 2010 edition of Top 10 Topics for Directors, we discussed 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. Our 2010 edition is available here.

3. Executive Compensation

Perennially in the spotlight, executive compensation will continue to be a hot topic for directors in 2012. According to ISS’s annual policy survey, 60 percent of investors and 61 percent of companies identified executive compensation as a priority issue. As companies move towards the 2012 proxy season, they will need to decide whether any changes to their pay practices should be made in response to the results of last year’s inaugural shareholder say-on-pay vote. In addition, increasing media coverage of the pay disparity between CEOs and average workers, as well as heightened focus on wealth inequality in the United States, will put additional pressure on boards to justify pay practices. Companies should also be taking into consideration new SEC rules that are scheduled to go into effect for the 2013 proxy season requiring disclosure in proxy statements of how executive compensation relates to the company’s financial performance as well as disclosure of the CEO’s compensation relative to median employee pay.

2011 was the inaugural year for shareholders of most public companies to have a vote on their company’s executive compensation practices. And, for the most part, shareholders seemed quite content, with support averaging 91.4 percent in favor of companies’ pay programs. However, say-on-pay proposals failed at 45 companies, a surprisingly high number given analysts’ expectations and the track record for say-on-pay in other countries. And at approximately 170 companies, shareholder disapproval levels exceeded 30 percent. The primary drivers of the negative votes were perceived disconnects between what the company pays its executive officers and the company’s actual performance, as well as the use of certain pay practices that have been labeled “problematic” by proxy advisory firms, including excessive perquisites, tax gross-up payments, excessive severance pay and single-trigger change-in-control payments.

We highlight below some of the matters companies should be considering as they craft executive compensation for 2012:

- **Impact of Last Year’s Say-on-Pay Vote.** Certainly, companies with failed say-on-pay votes will need to seriously consider whether changes to their pay practices should be made. Many companies with less-than-stellar results will also be taking a hard look at their compensation arrangements. According to the ISS annual survey, over half
of companies surveyed believe that the board should improve compensation practices if the negative vote on say-on-pay exceeded 40 percent, while 72 percent of investors want companies to make improvements if negative votes exceeded 30 percent. Moreover, a recent survey by Towers Watson showed that many companies that received strong shareholder support nevertheless intend to make some changes to their process for setting executive pay. Under SEC rules, companies are now required to disclose in their proxy statements whether—and, if so, how—they considered the results of the say-on-pay vote in determining their executive compensation policies and decisions.

- **Results of Say-on-Frequency Vote.** Based on say-on-frequency results from the 2011 proxy season, a majority of companies that have announced their decision have adopted an annual say-on-pay vote. Those companies that have a say-on-pay vote scheduled again for 2012 should be particularly sensitive to how shareholders perceive the company’s compensation practices.

- **Proxy Advisory Firm Recommendations.** Companies should consider ISS’s policies with respect to whether it will recommend a negative say-on-pay vote or a withhold vote on compensation committee members. Beginning in 2012, ISS will be using a more robust methodology to evaluate pay-for-performance, with more focus on longer-term trends in CEO compensation and total shareholder return (TSR). This new methodology will take into consideration (i) the degree of alignment between the company’s TSR rank and the CEO’s total pay rank within the company’s peer group, as measured over one- and three-year periods, (ii) the multiple of the CEO’s total pay relative to the peer group median and (iii) the alignment between the trend in the CEO’s pay and the company’s TSR over the prior five fiscal years. ISS will also perform a qualitative review on those companies demonstrating weak alignment. ISS’s 2012 policy also clarifies that ISS will recommend, on a case-by-case basis, whether to withhold votes on compensation committee members and to vote against the company’s say-on-pay proposal if the company’s previous say-on-pay proposal received the support of less than 70 percent of votes cast, taking into account the company’s response, including disclosure of the company’s efforts to engage major institutional investors regarding the issues that contributed to the low level of support, specific actions the company has taken to address such issues and other recent compensation actions taken by the company. ISS will also take into account whether the issues raised are recurring or isolated, the company’s ownership structure and whether the say-on-pay proposal received less than 50 percent support, which ISS believes would warrant the highest degree of responsiveness.

ISS certainly seemed to have an impact on 2011 results. During the 2011 proxy season, ISS opposed say-on-pay at 12 percent of the companies it covered, which included those companies where say-on-pay failed. And for those companies where the say-on-pay proposal passed despite the negative vote recommendation from ISS, over half received less than 70 percent approval, and 71 percent received less than 80 percent approval.

- **Company Response to Negative ISS Recommendation.** If a company receives a negative recommendation from ISS, it does not have to just passively accept it. Last year, several companies, including Walt Disney Co., ExxonMobil and Hewlett-Packard, went on the offensive by filing additional proxy materials to provide support for the company’s existing pay practices or to point out errors in the proxy advisory firm report. Companies also spent more time reaching out to institutional investors and other major stockholders regarding the say-on-pay vote; some companies even changed certain pay practices in an attempt to convince proxy advisory firms to reconsider their recommendations.

- **Impact of Withhold Votes on Compensation Committee Members.** With all the focus on say-on-pay, directors had a bit of a reprieve from against/withhold vote campaigns in 2011. But this reprieve may not continue into 2012, particularly if companies do not take action in response to shareholder concerns on executive compensation.

Companies that ignore shareholder concerns regarding executive compensation not only suffer the embarrassment and negative publicity of a failed say-on-pay vote, but also risk a shareholder lawsuit. Nine companies are facing shareholder derivative suits in the wake of receiving a failed say-on-pay vote in 2011. The lawsuits generally allege that the companies have excessive compensation practices and include claims against directors alleging that they breached their fiduciary duties by (i) diverting corporate assets to executives, which put the executive’s interests ahead...
of shareholder interests, (ii) misrepresenting or failing to disclose whether compensation was paid to executives in contravention of the company’s “pay-for-performance” compensation policies and/or (iii) engaging in corporate waste due to the alleged excessive size of executive compensation awards. These lawsuits also typically include claims against company officers for, among other things, unjust enrichment, and many include claims against compensation consultants used by the boards.

The future of these shareholder derivative suits is unclear. The Dodd-Frank Wall Street Reform and Consumer Protection Act makes clear that say-on-pay votes are only advisory in nature and also expressly provides that a negative say-on-pay vote may not be construed to create or imply any change in a director’s fiduciary duties. And under the business judgment rule, directors have historically had broad discretion when determining executive compensation, so long as they act on an informed basis, in good faith and in what they reasonably believe to be the best interest of the company. That being said, a federal court in Ohio (applying Ohio law) recently denied a motion to dismiss in the Cincinnati Bell case stating that there was a plausible claim that the multimillion-dollar bonuses, approved by directors at a time when the company’s financial performance was declining, violated the company’s pay-for-performance policy, were not in the shareholders’ best interest and constituted an abuse of discretion and/or bad faith. In contrast to Cincinnati Bell, a Georgia state court (applying Delaware law) recently dismissed the Beazer Homes case, concluding, among other things, that the plaintiffs failed to rebut the business judgment presumption.

So where does this leave us? Even though many commentators are critical of the court’s decision in Cincinnati Bell, the fact that the suit survived a motion to dismiss will likely spur more of these types of suits in the future—which makes a company’s compensation decision-making process and related disclosures on its rationale, particularly in relation to the company’s performance, all that more important.

Pending Dodd-Frank Regulations. Much to the delight of companies, the SEC has pushed back its rulemaking on several provisions that originally were scheduled to be in place by 2012. Although rules in these areas have not yet been adopted, companies need to be prepared for how the new rules will impact the company and should begin planning how the company will implement and comply with the new rules once adopted.

- **Pay for performance and pay disparity disclosures.** One of the Dodd-Frank Act’s more-contentious compensation provisions calls for companies to disclose in their annual proxy statements the relationship between executive compensation and the company’s financial performance, as well as the ratio of the CEO’s annual total compensation to the median annual total compensation of all other employees. SEC rulemaking on this is now scheduled for sometime between January and June 2012. Even though the rules will not be in effect for the 2012 proxy season, companies would be wise to begin laying the groundwork in their 2012 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.

- **Clawbacks.** The Dodd-Frank Act also calls for the SEC and stock exchanges to implement rules requiring companies to develop and disclose clawback policies for the recovery of incentive-based compensation granted to any current or former executive officer during the three-year period preceding an accounting restatement that is based on erroneous data corrected in the restatement. The language in the statute is broader than the clawback provisions in the Sarbanes-Oxley Act, which apply only to the CEO and CFO, have only a one-year look-back and require misconduct. The SEC has pushed back its rulemaking on this provision as well and currently plans to adopt related rules sometime between January and June 2012.

- **Compensation Committee Independence and Authority.** In response to a provision in the Dodd-Frank Act, in March 2011, the SEC proposed rules that would require the national stock exchanges to adopt listing standards augmenting the independence and power of compensation committees. 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. The SEC still expects to adopt final rules in 2011, and the exchanges are required to
have final listing standards in place within one year after the SEC’s final rules are published in the Federal Register.

Although most of the focus is on executive compensation, directors may also want to give some consideration to their own compensation practices. A recent survey on director compensation revealed that average director compensation packages now exceed $232,000, an increase of 8 percent over last year. The components of compensation are shifting at many companies as well. Most notably, companies continue to trend away from paying board meeting fees, with only 37 percent of companies surveyed paying such fees this past year, down from 57 percent in 2006. Instead, directors are enjoying more substantial retainers, with annual retainers averaging over $88,000, an increase of 11 percent from 2010. Also, more companies are issuing restricted stock rather than granting stock options to directors. In 2011, stock awards accounted for 48 percent of director compensation, while option grants accounted for only 10 percent.

4. It’s An Election Year: Do You Know Where Your Company’s Political Contributions Are?

Corporate participation in the political process has become a lightning-rod issue in the aftermath of the Supreme Court’s 2010 landmark Citizens United decision lifting most restrictions on corporate political spending. Although corporations still cannot make direct contributions to federal candidates and political parties, they are now free to use corporate funds for campaign advertisements directly supporting or opposing candidates or issues. They can also influence elections through contributions to trade associations and to nonprofit groups formed specifically to support political candidates or causes. In the wake of Citizens United, the 2012 elections are expected to draw an unprecedented flood of corporate funding. Before opening the corporate coffers, however, a company’s board of directors would be well-advised to review the company’s policies and procedures for political spending.

The Risks

Even a small misstep in the political arena can create major headaches for a company. Among the risks that companies need to consider are—

- **Reputational risks:** A political misstep can easily tarnish a company’s brand, particularly when a company endorses a candidate or cause that is inconsistent with the company’s core values. Last year, Target Corporation found itself embroiled in controversy over its donations to a pro-business organization that supported an anti-gay candidate. The company, which espouses progressive policies, was hit with demonstrations, negative publicity, a cancelled endorsement by Lady Gaga and questions from angry shareholders at its annual meeting. It ultimately apologized and promised to review its controls over political spending.

- **Legal risks:** In addition to federal regulations, corporations are subject to myriad state and local campaign finance laws and “pay-to-play” restrictions that must be carefully navigated. Many of these laws carry stiff criminal penalties if violated.

- **Business and disclosure risks:** Corporations need to carefully weigh the expected benefits from political spending against the risk of alienating customers and investors who might disagree with the company’s support of particular candidates or causes. Of course, a company might be able to avoid this risk by not disclosing its political contributions. Federal law does not currently require corporations to disclose their political expenditures. However, it may only be a matter of time before most public companies are disclosing how they spend their political dollars. Shareholder proposals calling for more disclosure were popular in 2011, appearing in proxy statements more often than any other type of proposal. The proposals garnered an average of 32.5 percent support, up from 9 percent just six years ago. At Sprint Nextel, a shareholder proposal won 53 percent of the shares voted. In its policy updates for the 2012 proxy season, ISS announced that it will generally support such proposals. In addition, following Citizens United, a number of states enacted legislation requiring greater disclosure of corporate political spending; similar legislation has been introduced in Congress. Recently, a group
of law professors petitioned the SEC to adopt rules requiring public companies to disclose their political spending. Over half of the S&P 100 already provide disclosure to varying degrees, either on their own initiative or in response to pressure from activists. This fall, the Center for Political Accountability sent letters to 423 companies in the S&P 500 urging them to adopt political spending disclosure policies before the 2012 proxy season to avoid facing a possible shareholder resolution on the subject.

The Board’s Role
Oversight of political spending is part of the board’s larger role in overseeing risk management. To assist boards in this new area of risk, The Conference Board has published an informative Handbook on Corporate Political Activity. In addition, several studies on the political spending practices of S&P 100 and S&P 500 companies were published this fall. While some boards address political spending through the board as a whole, most boards delegate oversight to the nominating and governance committee or a public affairs committee. As with other risks facing the enterprise, the board or assigned committee should make sure that the company has effective policies and procedures in place governing political spending. Among other things, directors should—

- **Be informed.** Many boards of directors are unaware of their company’s political activities. In addition, a recent study showed that most directors incorrectly believed that companies must report all of their political contributions. Directors need to make sure that they are up to speed on their company’s existing political spending practices.

- **Decide extent of giving.** The board as a whole, or through an assigned committee, should decide whether, and to what extent, the company should be participating in the political process. Some companies, including IBM and Colgate-Palmolive, do not permit any corporate political spending. Most companies, however, view political spending as an important means to fostering public policies that are consistent with their business objectives. While the fundamental decision of whether to engage in political activity is often addressed at the board level, few companies require prior board or board committee approval of actual political spending decisions.

- **Review/establish policies and procedures.** The board or assigned committee should make sure that the company has effective policies and procedures in place. Among other things, the policy needs to address who decides how the corporate funds are doled out, how decisions are vetted to ensure donations are consistent with the company’s core values and which types of candidates and organizations are appropriate recipients of corporate largesse. Merck Corporation, for example, does not permit contributions to judicial candidates. Twenty-four companies in the S&P 100 prohibit use of corporate funds for independent expenditures of the type allowed by *Citizens United*. Some companies ban or restrict contributions to trade associations and other tax-exempt groups that are not required to disclose their donors or how they spend their political dollars. Some companies have even dropped their memberships in politically active trade associations whose positions or issues clash with company values. For example, Apple, PG & E, and Exelon all withdrew from the U.S. Chamber of Commerce due to disagreements with the Chamber’s stance on climate change.

- **Decide whether and what to disclose.** In weighing the risks of disclosure, companies need to assess the likelihood of alienating customers and investors if campaign contributions are disclosed against the potential benefits of strengthening investor relations by being able to demonstrate that corporate funds are being spent in ways consistent with company values. In light of increasing demands for transparency, some companies may decide that being proactive in their disclosures is the best course. Several major S&P 100 companies now divulge all of their political spending, including the portion of company dues to trade associations that are used for political and lobbying purposes. With the election year upon us, and political watchdog groups hounding companies, boards should carefully review their company’s political spending practices and make sure that appropriate safeguards are in place.
5. 2012 Elections

Regardless of whether their company decides to take an active role in the political process, directors of public companies will need to keep a close eye on the 2012 Presidential and Congressional elections. While the two major political parties are still months away from finalizing platforms, it is clear that the two parties have sharply divergent views on a wide range of issues that will significantly impact businesses, including how best to address the ballooning federal deficit, the rising cost of entitlement programs, high unemployment, health care reform, tax reform and repatriation of overseas earnings. Indeed, 2012 will likely be a watershed year for the direction of the country if either party succeeds in getting control of both the White House and Congress. Given the stark contrast between the two parties’ positions as well as the acrimony displayed this past year over the debt ceiling vote, the 2012 elections no doubt will prove to be one of the most rancorous ever. In addition, the Occupy Wall Street movement and media focus on the “1 percent” will add fuel to the political fires and also may spark civil unrest as America’s promise of upward mobility rings hollow for a growing portion of the population.

6. Minding Your Ps and Qs: Regulators Step Up Anti-corruption Efforts

Directors should make sure that their companies have robust compliance and ethics programs in place, as governments throughout the world are stepping up their enforcement efforts under anti-corruption and anti-bribery statutes. The price for getting caught under one of these statutes can be very high. In addition to the reputational damage, companies can face criminal prosecution, significant fines and penalties (sometimes running into hundreds of millions of dollars), investor lawsuits and continuing oversight to ensure future compliance. Moreover, the risk of getting caught has gone up. In August 2011, new SEC whistleblower rules went into effect that offer enormous incentives to employees and others to report securities law violations, including violations of the main U.S. anti-corruption statute, the Foreign Corrupt Practices Act (FCPA).

The SEC and the Department of Justice have been ramping up their enforcement efforts under the FCPA for the past several years. In 2010, the agencies brought 74 enforcement actions, up from just 15 five years ago, and they collected a record $1.8 billion in monetary penalties. The fines and settlements are often staggering, and eight of the top 10 monetary settlements were reached in 2010 and 2011. The largest settlements include $800 million paid by Siemens A.G.; $579 million by Halliburton and its subsidiary KBR; and more than $330 million by each of BAE Systems, ENI/Snamprogetti and Technip. In addition, the government does not stop with companies and often goes after the individuals involved. In 2010, 51 individuals were prosecuted, more than double the number targeted in 2008.

The onus of the FCPA is due not only to the sheer breadth of its reach, but also to the ease with which companies can unwittingly violate its proscriptions. Companies can be liable for the actions of their agents and joint venture partners. Failure to conduct thorough due diligence in an M&A transaction can expose an unwitting buyer to liability for the target’s past FCPA infractions. Foreign companies can be dragged into the statute’s net if their securities are traded on a U.S. exchange or if they channel payments through their U.S. operations. And earlier this year, two courts held that employees of state-owned enterprises can qualify as “foreign officials” for purposes of the statute.

New SEC whistleblower rules provide the government with a powerful new detection tool for FCPA violations. Under these new rules, individuals, including employees, can earn cash bounties ranging between 10 and 30 percent of the monetary sanctions collected in SEC enforcement actions and related government actions. With fines and penalties in FCPA cases often running into hundreds of millions of dollars, the lure of whistleblower bounties will serve as a powerful incentive to employees and others to report company misconduct to the SEC.

The United States is not alone in its efforts to stamp out corruption. According to Transparency International, 16 of the 38 member states of the Organisation for Economic Co-operation and Development are now active or moderately active in their enforcement efforts under the organization’s anti-bribery convention, double the number from six years ago. In addition, in July 2011, the United Kingdom’s far-reaching Bribery Act went into effect. The new U.K. statute poses significant additional risks for companies that carry on business in the U.K. or are incorporated there. The new law goes further than the FCPA in several important respects, for example by barring not only bribery of public...
officials but also private-sector bribery and by barring even low-level facilitation payments. Perhaps the most significant aspect is the new strict liability offense of failing to prevent bribery, which applies where anyone “associated” with a company pays a bribe to benefit that company. It is irrelevant where in the world the bribe takes place and whether management was or should have been aware of it; the only defense is that the company had in place “adequate procedures” to prevent bribery, which, in practice, amounts to a reversal of the burden of proof. Therefore, for the first time, there is a de facto requirement for companies to have in place appropriate written compliance policies and procedures in order to avoid committing an offense.

The U.K. Ministry of Justice has published guidance on the new statute that appears to rein in some of its jurisdictional reach and that also includes principles companies should follow in making sure their compliance procedures are adequate. Due to budgetary and other constraints, it remains to be seen how vigorously the Bribery Act will be enforced. U.K. enforcement officials have expressed interest in husbanding their limited budget, in part, by piggybacking their prosecution efforts onto those of other countries. Since the United States is the most active country prosecuting bribery cases, this poses a particular risk for U.S. companies doing business in the U.K., and they should make sure that their anti-bribery programs are both FCPA- and Bribery Act-compliant.

In addition to anti-bribery concerns, companies should also be sensitive to the proliferation of economic and trade sanctions imposed by countries around the globe. The European Union and its member states, as well as a number of other countries, have recently expanded their sanctions programs in ways that differ significantly from the U.S. program, posing new challenges for companies with a global footprint. Moreover, the U.S. Office of Foreign Assets Control (OFAC), which enforces U.S. economic and trade sanctions against targeted countries, terrorist organizations, narcotics traffickers and others deemed hostile to the United States, has been stepping up its enforcement efforts. The agency collected almost $1 billion in fines and penalties in 2009 and 2010, compared to less than $8 million in the prior two-year period. Every U.S. person (which is broadly defined to include, among others, U.S. citizens, entities and individuals located in the United States, overseas branches of U.S. companies and, in some instances, foreign subsidiaries owned or controlled by U.S. companies) must comply with OFAC’s regulations. OFAC currently restricts or prohibits doing business with more than a dozen countries and thousands of companies and individuals identified on OFAC’s Specially Designated Nationals and Blocked Persons list. Because OFAC’s programs are complex and constantly changing, companies need to have in place compliance programs that properly screen customers, suppliers and other counterparties to transactions and also carefully monitor more indirect ways of falling within OFAC’s snare by violating its tricky reexport and facilitation provisions. The consequences of failing to comply can be quite severe: statutory criminal penalties include fines up to $1 million and imprisonment up to 20 years per count and civil penalties can be as high as the greater of $250,000 per act or twice the value of the transaction being penalized.

In light of these developments, it is critical for companies to have robust compliance programs in place. As part of their oversight of risk management, boards should make sure that their companies are reviewing—and, if necessary, upgrading—their compliance programs.

7. Board Composition

With increasing globalization and changing marketplace dynamics, it is essential that boards of directors have the right mix of experiences and competencies to oversee the new opportunities and risks that their companies face. Companies seeking to enter international markets or further their global reach may well benefit from the insights of a director with international experience. Similarly, as the Internet and social media play an expanding role in business, boards of almost all companies may find that they would gain from the addition of a tech-savvy director. In a recent survey, 46 percent of directors polled believed that their board’s ability to oversee their company’s strategic use of technology and related risks was less than effective. Risk management is another area where companies may need to beef up their boards. Although boards have come a long way in their oversight of risk management since the financial crisis, many boards would still benefit from the addition of a director with in-depth experience in enterprise risk management.

While the benefits of new perspectives on a board seem clear, many boards are having difficulty refreshing their ranks. According to the latest Spencer Stuart Board Index, during the 12 months ended May 15, 2011, the boards of S&P 500
companies elected only 294 new directors, the lowest number in 10 years. The data also show that the average S&P 500 board is getting older (the average age is now 62.4 compared to 60.2 in 2001), smaller (10.7 directors compared to 11.1 in 2001) and serving longer (now 8.7 years). Spencer Stuart surmises that the low director turnover may be due to downsizing of boards, the raising of mandatory retirement ages and fewer voluntary director resignations during the economic downturn. With average annual director compensation now topping $232,000, it is not surprising that directors are holding on to their board seats.

Directors themselves acknowledge that their boards may be getting stale. In one recent survey, director recruiting was one of the top five issues to which directors had given a high degree of focus in the past year. According to another survey, more than half the directors believed that director turnover was too low, which is due, at least in part, to a widespread assumption of director “tenure.”

This mindset can create challenges for the nominating and governance committee. To better align board composition with company needs, this committee should first determine the optimal mix of talents and experiences that will help the company achieve its strategic plan and manage its risk profile and then identify any gaps in the current board composition. By focusing on the company’s future and the attributes and skills needed to get the company there, this approach avoids criticism of any individual director’s experiences or skill set and provides a clear path towards achieving greater board competency.

Of course, myriad factors need to be considered in building an effective board. In addition to industry experience and financial expertise, as well as a host of other competencies, boards need to determine the extent to which diversity should be a factor in the optimal mix of attributes and skills needed. Companies are now required to disclose in their proxy statements whether and how the board or nominating committee considers diversity in identifying director candidates. Even though many companies say they are committed to achieving a diversified board, the percentage of minority directors and women serving on boards has barely budged in the last five years: women now account for just over 16 percent of independent directors on S&P 500 company boards, compared to 15 percent in 2006, and minority directors at the 200 largest S&P 500 companies account for just 15 percent of all directors, the same as five years ago. Many companies claim that a shortage of qualified candidates limits their ability to diversify. It is interesting to note, however, that at the 15 S&P 500 companies led by a woman, women directors comprise 33 percent of all board members, while women comprise just 16 percent of directors of companies with male CEOs.

Finding the right mix of people to serve on the board is undoubtedly a difficult task. One wrong move can easily sour a board’s working chemistry and cohesiveness. Understandably, boards do not take the addition of a new member lightly: in a recent survey, 71 percent of directors considered it moderately difficult to extremely difficult to gauge whether a prospect will be a good fit for their board. While the challenges should not be overlooked, they also should not serve as a roadblock to changes that can bring needed competencies and fresh perspectives to the board and help propel the company to the next level.

8. Health Care Reform

Health care reform will be a hot topic in the boardroom in 2012. While the initial wave of the federal health care reform legislation has already kicked in, certain key provisions of the law are scheduled to take effect in 2014. Because these provisions will have a major impact on most companies, boards of directors need to be planning now how their companies will comply with these regulations and the effect such compliance will have on their company’s cost structure and strategy going forward. At the same time, boards will also need to monitor challenges to the law that could invalidate some, or possibly all, of its provisions. Several lawsuits challenging the statute have been filed, and courts have reached conflicting decisions. In March 2012, the U.S. Supreme Court will hear oral arguments in a case challenging the constitutionality of the Patient Protection and Affordable Care Act’s requirement for individuals to purchase health care insurance or pay a penalty, claiming that the individual mandate provision is not a proper exercise of Congress’s Article I commerce power or taxing power. The U.S. Court of Appeals for the 11th Circuit held that the statute’s individual mandate was unconstitutional but that the provision could be severed from the rest of the statute. In addition to addressing the constitutionality issue, the Supreme Court will also consider whether a challenge
to the statute at this time is premature under a federal law that bars suits challenging a tax before it has been paid, which, in this case, would not occur until 2015 when penalties (if they are deemed taxes) would be due for failing to obtain insurance. If the U.S. Supreme Court were to conclude that the individual mandate is unconstitutional and not severable, the entire statute could be struck down. While the court cases and calls by some Republicans for reform or repeal of the legislation bring a measure of uncertainty to the future of health care reform, companies nevertheless should not delay planning lest they be caught unprepared should the challenges fail.

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

State Insurance Exchanges. By January 1, 2014, each state is required to establish a health insurance exchange that, among other things, will facilitate the purchase of and make available “qualified health plans” to qualified individuals and employers. Employees of companies with fewer than 50 full-time employees will generally be eligible to purchase insurance within the state insurance exchange and possibly receive a federal subsidy without any penalty to the company. But, as discussed below, larger companies with employees who purchase insurance through these exchanges will be required to pay a penalty.

Play-or-Pay. The statute does not require employers to provide health insurance to employees. But beginning January 1, 2014, employers with 50 or more full-time employees, referred to as “large employers,” will have to pay a penalty if (i) they do not offer health insurance to employees or (ii) they offer health insurance to employees, but it does not meet certain affordability or benefit requirements. If a large employer does not offer health insurance, and one or more of its employees enrolls in a state insurance exchange and receives a federal government subsidy, the employer will be required to pay a fee of $166.67 per month ($2000 annually) for each full-time employee, excluding the first 30 full-time employees. If a large employer does offer health insurance, but one or more of its employees nevertheless enrolls in a state insurance exchange and qualifies for a federal government subsidy, the employer will be required to pay the lesser of (i) $166.67 per month ($2000 annually) for each full-time employee, excluding the first 30 full-time employees, and (ii) $250 per month ($3000 annually) for each full-time employee who receives the subsidy.

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

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

- **Assess strategy and costs relating to play-or-pay.** Most companies that currently offer health benefits to employees are expected to continue to do so for the foreseeable future. Because health benefits are often viewed as an important part of an employee’s compensation package, eliminating health care coverage for employees and paying the penalty may not be a viable option for some companies. But it will be important for the board of directors to know the company’s options and responsibilities under the statute to best determine whether the company should take the “play” or “pay” approach in 2014. In making this determination, the board should consider, among other things, (i) the costs of the company’s health care programs and what steps the company can take to manage these costs, (ii) the amount of any penalties the company would have to pay under the statute if it eliminated health care coverage for its employees and (iii) the actions taken with respect to health care by other companies in the industry. If the company does elect to “pay” instead of “play,” it will need to carefully consider how to explain its decision to employees and inform them of their options.

- **Review and redesign, if necessary, current health care programs.** The cost for health care is high, with employers paying 36 percent more for health care, and employees contributing 45 percent more than they did just five years ago. Companies should be using health care reform as a catalyst to review and redesign their health care programs as necessary to slow these rising costs. Many companies are already taking steps to manage health care costs by, among other things, increasing the share employees and their dependents pay in premium contributions,
using waivers or surcharges for spouses who have other available coverage, implementing higher medical and
pharmacy deductibles, eliminating retiree health benefits, encouraging enrollment in high-deductible health plans
and reviewing the company’s relationship with its providers.

Managing costs will become even more significant for companies as 2018 approaches and the excise tax for high-
cost plans kicks in. Research shows that, based on current projections, a majority of companies expect to hit the
excise tax threshold in 2018 and plan on making changes to their health care plans in the coming years to get their
costs below the threshold.51

• Stay abreast of developments. Because of the statute’s sheer volume and complexity, education is key to ensuring
that directors understand the statute’s relevant provisions, their effective date(s) and the implications they will have
on the company. Boards also need to be fully informed of judicial developments and any evolving guidance and
interpretive regulations relating to the implementation of the law so they can effectively formulate a strategy for
dealing with it going forward.

• Encourage a healthy workforce. Having a healthy workforce can give a company a competitive advantage.
Companies should consider increasing their commitment to improving the health of their workforce by focusing on
wellness initiatives to promote prevention and employee health and adopting or expanding the use of financial
incentives to encourage healthy behaviors.

9. Keeping an Eye on Proxy Access

In September 2011, new SEC rule amendments went into effect that require companies to include in their proxy
materials shareholder proposals seeking to amend company governing documents to give shareholders direct access to
company proxies for inclusion of their director nominees. Most commentators do not expect companies to see a flood
of such proposals next year. Nevertheless, it would be wise for boards of all public companies to keep an eye out for
any developing trends since early shareholder successes could snowball into a much larger movement. While some
analysts have speculated that prodigious use of Rule 14a-8 might undermine continuing efforts by activists to have
some form of universal proxy access ultimately adopted,52 the Council of Institutional Investors has warned that
“Council member funds and the broader investor community are ready and willing to seek access to the proxy to
nominate directors judiciously, at companies where boards have been asleep at the switch or chronically unresponsive
to shareholder concerns.”53 Consequently, at least those companies with ongoing corporate governance issues should
be prepared for the possible submission of proxy access proposals. And if the history of other investor-led governance
initiatives, such as majority voting, is any guide, the most likely targets in the first year of proxy access will be large,
higher-profile companies.

The amendments to Rule 14a-8 went into effect after a federal court struck down another SEC rule, Rule 14a-11, that
would have mandated proxy access for all companies. As a result of the changes to Rule 14a-8, shareholders will have
the flexibility to propose amendments to company governing documents that would establish proxy access standards on
a company-by-company basis, rather than the “one-size-fits-all” approach provided in Rule 14a-11. Rule 14a-11 would
have given proxy access only to shareholders who have continuously held at least three percent of the voting power of a
company’s securities for three consecutive years and would have capped the total number of shareholder nominees at
25 percent of the board. It is likely that shareholder proposals submitted under Rule 14a-8 will have lower thresholds
for proxy access than those imposed by Rule 14a-11. Many institutional investors have favored a lower ownership
threshold (such as one percent) at larger-cap companies and a one- or two-year holding period. In addition, United
States Proxy Exchange, which represents retail activists, recently published a model proxy access proposal that
contains a one-percent ownership threshold and a two-year holding period and also provides that any group of 100 or
more shareholders who each meet Rule 14a-8’s eligibility requirements can have their nominees included in the
company’s proxy materials.

We expect most companies to simply sit tight and closely monitor developments as they unfold. However, companies
that are likely targets of proxy access proposals should begin evaluating their options now. Certainly any company that
receives a proxy access proposal should take it seriously. In 2007, before the SEC clarified that Rule 14a-8 did not then permit proxy access proposals, proxy access proposals at UnitedHealth and Hewlett-Packard each received over 40 percent shareholder support. And a majority of shareholders voted in favor of a proxy access proposal at Cryo-Cell International, a small-cap firm. For a discussion of considerations for those companies that are either targets or likely targets of a proxy access proposal, please see our client alert on this topic, which is available here.

10. Succession Planning

Recent headlines regarding CEO succession at high-profile companies, such as Apple, Hewlett-Packard and Yahoo!, emphasize the importance of having an effective succession plan in place. A change in leadership, whether due to a planned retirement, poor performance, health issues or a sudden departure, is one of the most challenging responsibilities that boards may face. And the more prepared a board is, the smoother the transition will be—which may be why, according to a recent survey, 59 percent of directors said they would like to increase the amount of time and focus their board gives to succession planning.54

Over the past few years boards have increasingly recognized the importance of succession planning, with boards of almost all S&P 500 companies discussing CEO succession planning at least once a year.55 But while 83 percent of S&P 500 boards have adopted an emergency succession plan, and 76 percent have a long-term plan in place, that still leaves over 30 percent lacking either an emergency or long-term plan. Moreover, according to a recent survey, 43 percent of directors polled identified CEO succession planning as the responsibility for which their board was least effective.56

When boards are forced to deal with a CEO’s departure, the strength of the company’s succession plan—or its 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, which can impact not only the company’s strategy, but also investor confidence, employee morale, the company’s reputation and its stock price.

Although much of the focus is 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.

So what should boards be doing? First of all, directors should periodically have in-depth discussions on succession planning, preferably quarterly, but at least once a year. In these discussions, directors should consider several factors, including the company’s strategy, the company’s strengths and weaknesses, where they want the company to go and any particular challenges facing the company. This discussion should help give boards a better understanding of the leadership talent and skills necessary for top positions. Although boards may be having these discussions, according to a recent survey, 58 percent of respondents revealed that their boards do not have a written description of the requisite CEO skills and experiences.57 Once these are understood, the board needs to make sure it has the right process in place to get the job done.

The succession process among boards varies. At most companies, the full board is responsible for succession planning, while, at others, this task is delegated to the compensation committee or nominating and governance committee. Regardless of who is charged with the task, potential candidates, both internal and external, need to be identified. If the candidates are internal, the board should take a proactive role in grooming candidates for the position at hand by ensuring they have the right leadership skills and are receiving necessary training for the position. And for internal candidates, the board should be identifying potential candidates to fill that person’s position if he or she is promoted. The board should also expand the field by identifying potential external candidates who may have the requisite talent to lead the company. The larger the pool of candidates a company has to consider, the more likely the board will be able to find the right person for the job.
Because CEO succession is a rare event for most companies, succession planning often gets pushed to the back burner while boards address more urgent day-to-day obligations. But, rather than reacting to shareholder angst or to a health issue, corporate scandal 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 if the need arises.

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2 The phrase was coined by Mohamed El-Erian.
6 Id.
7 “Getting a Grip on Governance: Results of the 2011 Corporate Board Member/FTI Consulting 2011 Legal Study,” Board Member 2011 Special Supplement.
11 ISS 2011-2012 Policy Survey Summary of Results, supra at 4.
14 Id.
15 Id. at 10. In its qualitative review, ISS will consider (i) the ratio of performance- to time-based equity awards, (ii) the ratio of performance-based compensation to overall compensation, (iii) the completeness of disclosure and rigor of performance goals, (iv) the company’s peer group benchmarking practices, (v) actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both absolute and relative to peers, (vi) special circumstances related to, for example, a new CEO in prior fiscal year or anomalous equity grant practices (e.g., biennial awards) and (vii) any other factors deemed relevant.
16 Id. at 8.
17 Alliance Advisors, “Shareholders Have Their Say on Pay, But What Exactly Are They Saying” (July 2011), at 2.
18 Id.
19 These companies include Occidental Petroleum Corporation, Umpqua Holdings Corporation, KeyCorp, Jacobs Engineering Group, Beazer Homes USA, Hercules Offshore, Inc., Janus Capital Group, Cincinnati Bell and Dex One Corp.
20 Section 951 of the Dodd-Frank Act.
23 The independence requirement in the Dodd-Frank Act closely tracks the independence standard imposed on audit committees 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.
25 Id. at 37.
26 Id. at 36.
27 Id. at 35.
29 See id. at note 15; see ISS 2011 U.S. Postseason Report, supra at 27.
30 In its policy updates for the 2012 proxy season, ISS announced that it will generally recommend that clients support shareholder proposals requesting greater disclosure about corporate political spending, considering the company’s current disclosure about its policies and oversight mechanisms, including information on the types of organizations supported and the business rationale, and any recent significant controversies or litigation concerning the company’s political contributions or activities. Previously, ISS had evaluated such proposals on a case-by-case basis.
33 The Conference Board, Handbook on Corporate Political Activity, supra at 19.
34 The CPA-Zicklin Index, supra.
35 On a closely related topic, however, few public companies provide easily accessible information on the amount of corporate funds they spend on lobbying. According to one study, 80 percent of S&P 500 companies spent money on lobbying efforts at the federal level in 2009 and 2010 based on information gleaned from federal records, but only 13 of these companies either disclosed on their Web sites how much they spent on lobbying or provided a link to the federal reports. H. Welsh and R. Young, IRRC Institute, Corporate Governance of Political Expenditures: 2011 Benchmark Report on S&P 500 Companies (Nov. 2011), at 19. There will likely be an increase in 2012 in shareholder proposals calling for better disclosure
of corporate lobbying expenditures after the SEC staff allowed certain formulations of such proposals this past year. See id. at 73.


37 For example, under the guidance, merely listing securities on the London Stock Exchange would not by itself constitute carrying on business in the U.K., nor would having a U.K. subsidiary necessarily mean that its parent company is carrying on business in the U.K.


39 2011 Spencer Stuart Board Index, supra at 5.

40 Id. at 5, 18.

41 Id. at 10.

42 Id. at 35.

43 Id. at 7.

44 Heidrick & Struggles and Rock Center for Corporate Governance, 2011 Corporate Board of Directors Survey, at 2.


46 2011 Spencer Stuart Board Index, supra at 19, 20; Spencer Stuart 2006 Board Diversity Report.

47 2011 Spencer Stuart Board Index, supra at 19.

48 Heidrick & Struggles and Rock Center for Corporate Governance, 2011 Corporate Board of Directors Survey at pg. 2.


52 Proxy access proponents continue to urge the SEC to adopt a mandatory rule. On September 13, 2011, a coalition of 14 pension funds and institutional investors called on the SEC “not to give up” and to issue new rules providing for universal proxy access. Calpers press release, “Investors Urge New Rule on Proxy Access” (September 13, 2011), available at http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2011/sept/proxy-access.xml. The court decision vacating Rule 14a-11 does not preclude the SEC from again proposing mandatory proxy access rules, as the decision was based on the SEC’s failure to satisfy procedural requirements under the Administrative Procedures Act. In the SEC release announcing that it would not appeal the decision, SEC Chairman Shapiro stated that she “remains committed to finding a way to make it easier for shareholders to nominate candidates to corporate boards.” However, SEC reconsideration of proxy access is not expected to occur in time for the 2012 proxy season in view of the strong criticism leveled by the court of the SEC’s procedures and the large body of other rule-making on the SEC’s agenda.


54 PwC Annual Corporate Director Survey 2011 Findings, supra.

55 2011 Spencer Stuart Board Index, supra at 33.

56 2011 Spencer Stuart Board Index, supra at 3, citing recent Corporate Board Member survey of directors of New York Stock Exchange listed companies.

57 Id.