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Board Focus 2010: Issues and Developments

Many boards have been subject to significant external pressure to improve their performance, and many have undertaken their own performance reviews. The Delaware Court of Chancery provided some much needed perspective when, squarely in the heart of the financial crisis, it reaffirmed the continued vigor of the business judgment rule. The case, *In re Citigroup Inc. Shareholder Derivative Litigation*,[1] stands for the proposition, among others, that "only a sustained or systemic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability."

The *Citigroup* decision does not, however, diminish the importance and growing number of practical issues facing directors, nor the scrutiny they will increasingly face from shareholders and the government alike. We highlight several of these issues below. While we have not called it out specifically, information flow is important to how boards address each of these issues. As director workload increases, boards and management are well-advised to consider the content and timeliness of pre-read materials and the importance of board preparation to ensure the most effective foundation for board deliberations.

Oversight of Risk Management

Many boards have now expanded risk oversight beyond the financial control focus of SOX to encompass enterprise-wide risk analysis – not to eliminate or merely mitigate risk, but to calibrate strategic goals to desired levels of risk exposure. The effectiveness of the exercise depends on a recurring process that assesses the evolution of risk exposures with changes in performance, the competitive landscape and other factors.

- ***Strategic review a key predicate of risk oversight.*** A critical predicate is the board's own ability to articulate the business strategy and the main risks that could drive tactical and strategic decisions in the near- and long-term. Boards that do not regularly focus on the company's strategic plan place themselves at a significant disadvantage in reaching consensus around the company's risk appetite, much less around the nature, relative importance and interplay of discrete risks facing the company. Identifying the vulnerabilities that could affect the company's plans or performance positions the board

[1] *In re Citigroup Inc. Shareholder Litigation*, 964 A.2d 106 (Del. Ch. 2009)

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to evaluate whether management has adequately mapped those risks to functional areas or reporting lines and whether other elements of the company's operation – notably compensation programs – support performance goals on a risk-adjusted basis.

- ***Board structure must complement management practices.*** Management practices to address risk must be complemented by a board structure that maps oversight responsibility to the board as a whole or to its committees. We sometimes hear that the audit committee bears the principal responsibility for risk oversight, and for NYSE-listed companies, the governance rules about the role of the audit committee may have reinforced this view. Over-reliance on this approach seems flawed for many reasons, but the most important is that the full board should oversee enterprise risk, given its role in guiding management in strategic matters and the importance of the diverse perspectives offered by a broader group. Tasking a single committee with enterprise risk oversight also fails to take advantage of other committee competencies that relate to risk and can be leveraged to refine the board's appreciation of the company's risk profile.

- ***Review of board and committee risk oversight responsibilities.*** The financial crisis has prompted many boards to reconsider how they oversee risk exposures, a process that will surely accelerate with the new proxy statement disclosure requirements about the board's role in risk oversight. Some commentators, including sponsors of pending Congressional initiatives, have argued that public companies should have separate risk committees, an approach that may make sense particularly for financial services companies for which assuming risk is at the core of the business strategy. Some boards have established finance committees to oversee policies and procedures relating to treasury risks, such as capital allocation or dividend policies and practices and controls relating to the use of derivative instruments. Boards of some highly regulated companies now have compliance committees. Many boards have also refined the mandate of the compensation committee to encompass leadership development, management succession and related risks. Boards should ensure that the allocation of responsibility fits the company's circumstances and addresses the spectrum of identified material risks.

Strategic Oversight

Since the advent of SOX, concern has regularly been expressed that boards have lost their balance and spend too much time on compliance and not enough on strategic oversight. Without taking sides in that debate, it is incontrovertible that a fundamental responsibility of boards is to provide support, advice and oversight of management's development of the strategic plan and the plan's execution. Boards, their advisors and meeting planners should ensure that board and committee pre-read materials and meeting agendas provide the information and the time needed for an effective strategic review. Regular focus on strategy should entail dedicated sessions of the entire board, scheduled at least annually, with robust

presentations and participation by management. Both management and directors should also consider how board and committee agenda items throughout the year can be considered from a strategic point of view, and not just as a means to "check the box" against a stock exchange- or SEC-mandated responsibility. An ongoing focus of this type, which would necessarily cut across a range of operational, financial and other matters, will enrich the board's dialogue with management about the strategic plan and lead to a more active posture of the board in its oversight of management's performance.

Management Succession Planning

Succession planning for the CEO and other top management positions promises to become a more prominent issue in 2010, particularly in the wake of SEC staff guidance that will permit many more shareholder proposals about succession to be included in the company's annual proxy statement.

- ***Defining the board's role.*** The board should define its own role and that of its committees in succession planning and determine which management positions are of such critical importance that they merit board-level consideration. In the case of the CEO, the exercise is a matter for the full board with input from the incumbent, whereas practice varies in the case of other executive positions, depending on the number of positions under review. Even where a board committee bears principal responsibility to lead succession planning for non-CEO positions, the board as a whole should be informed about the leadership development process and possible candidates. Succession planning should be revisited as circumstances dictate, but certainly no less frequently than once a year.

- ***Long-term planning in addition to crisis plans.*** It is no longer sufficient to address succession planning in a crisis setting; long-term succession planning for key officials mitigates business continuity risk and can be an effective means to provide compensation that is appropriate in both amount and design, particularly for the CEO position (it is, for example, well documented that internal candidates are less costly than external hires). In both cases, the scope of positions under review will depend on the company's size and complexity, with the scope being generally broader for long-term succession planning purposes.

- ***Input into leadership development.*** Boards should consider and provide input to the CEO and other members of management as appropriate about leadership development initiatives, both in terms of the substantive responsibilities of candidates, but also the exposure they should have to the board so that new executives are not new faces to the board. Management resistance to succession planning or to board involvement can be a sign of more serious issues, including not only lack of bench strength but also potential entrenchment issues. In that case, the board must promptly address the matter with the

CEO.

- ***Review of governance principles.*** Boards should review their governance principles to ensure that responsibility for succession planning is clearly allocated and the process adequately described, particularly in light of shareholder proposals in this area. While the typical proposal calls for disclosure of a company's succession plan, it would be clearly inappropriate for companies to disclose succession candidates, except possibly when a transition is expected in the near term.

Executive Compensation

The relationship between compensation incentives and risk continues to attract a wide spectrum of commentary. We have separately outlined factors relevant to an assessment of this relationship,[2] and we reprise key themes below. But the focus on compensation and risk should not obscure other areas of the compensation-setting process that deserve specific attention during 2010.

- ***Evaluating performance and setting goals.*** Most compensation committees evaluate prior period performance for long- and short-term incentive plans, and set future performance matrices and targets, in the first quarter of the calendar year. Both exercises should reflect a deep understanding of the drivers of the company's past and expected future results.

  Attention should be paid to unusual or non-recurring accounting items (both positive and negative items) and how they should be reflected in certifying reported results against performance matrices. Appropriate period-to-period consistency of treatment is a key point for consideration, but the underlying factors merit review. Were they expected, or surprises? Should adjustments to payouts be made to reflect the manner in which performance was attained? Should plan design, performance criteria or performance matrices be adjusted for future periods to take into account uncertainties about what will drive future corporate results? Are proposed performance goals appropriately aligned with bottom-up business planning, projections and goals?

  A related question concerns the extent to which plan design affords the compensation committee sufficient discretion to adjust payouts. Recently, plan design has trended towards objective formulas, which was thought to enhance pay-for-performance. However, in light of the difficulty of predicting the future and capturing assessments of performance through objective formulas set in advance, it is not obvious that well-

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[2] See our firm's memorandum to clients entitled "Compensation and Risk: Compensation Committee Actions Under New SEC Rules" (Dec. 17, 2009), available at http://www.cgsh.com/compensation_and_risk_compensation_committee_actions_under_new_sec_rules/.

thought out exercises of discretion are less valuable tools in determining pay than objective formulas.

These issues are sometimes given short-shrift. Compensation consultant analytical tools and data tend to focus on peer group actions and results, which can result in too little attention being paid by the compensation committee to the business of the company itself. Regulatory sensitivities have also grown over the participation of management in the compensation-setting process, because of the perceptions of a conflict of interest. Typically, however, management is the best source of information about performance issues. An optimal process will take that into account, without compromising the independence or ultimate authority of the committee's judgment.

- ***Clawbacks.*** Standards for the design of clawback provisions and policies are rapidly evolving. In part, the change has emanated from the regulatory focus on the financial institution crisis, in which there was significant (albeit hotly debated) sentiment that the time horizon of pay-for-performance arrangements in the financial services industry was too short. Many financial firms have now enhanced their ability to recoup compensation based on longer-term performance results.

  Most clawback policies have also focused on misconduct as a trigger, but recent surveys suggest a trend towards policies that provide for recoupment (or adjustments) in the event of "innocent" mistakes. The SEC staff seems to favor this approach, as reflected in two pending proceedings asserting clawback claims against public company CEOs without any attempt to plead their wrongdoing (although the relevant statutory provision requires misconduct and both cases involved accounting restatements occasioned by misconduct by other company personnel).

- ***CIC triggers.*** Change-in-control triggers in compensation arrangements are very common. Recently, there has been significant focus on the size of CIC benefits and the justification for "single trigger" benefits. Less public attention has been paid to a more technical aspect of these triggers, which is what kinds of transactions constitute CIC transactions. Various developments suggest that in many cases attention is warranted.

  First, CIC definitions were adopted by many companies years ago, and there have been few convenient opportunities to re-examine them in light of changes in transactional practices and in the legal interpretations of certain terms commonly used in those definitions. A likely future change – proxy access – is a further reason to review these CIC definitions.

  Second, a CIC event may be relevant for non-compensatory purposes, such as acceleration provisions under debt agreements or shareholder approval requirements under local law. Often, the determination to treat a circumstance as a CIC for these other purposes is motivated by factors that are not relevant to the compensation

program. However, the relevant documents are rarely clear about the relationship between the triggers they establish for different purposes, and few expressly contemplate that the same language may be interpreted differently under different agreements.

Third, many companies have adopted or inherited different CIC triggers in their various compensation plans and agreements. While there is rarely an opportune time to conform these provisions, and any changes could raise tax and other legal issues, boards should consider with management whether continued differences in approach are justified.

- ***Communications with shareholders and proxy advisory firms.*** Executive compensation issues will continue to figure prominently in the changing landscape of director elections and shareholder communications. But boards should be mindful that practical issues in the evaluation of compensation practices by institutional shareholders and proxy advisory firms create substantial risks of a one-size-fits-all mindset. This issue seems to be acknowledged by many institutional shareholders, as reflected in their willingness to meet with company personnel about compensation matters. Proxy advisory firms also seem to recognize the problem. RiskMetrics' 2010 Corporate Governance Policy Updates and Process Frequently Asked Questions on U.S. Compensation is replete with statements that voting recommendations are made on case-by-case basis. Whether thoughtful individual analysis is practicable, however, remains an open question. Boards and their compensation committees should therefore consider the following steps:

  - Convincingly communicate the company's pay-for-performance story. Since the Compensation Discussion & Analysis can easily become a legalistic response to disclosure requirements, consider an executive summary in which the story is told succinctly and in very plain English.

  - Eliminate to the extent practicable controversial pay practices and, for those that are retained, consider specific proxy disclosure justifying the practices in the context of the company's or executive's particular circumstances. RiskMetrics' Corporate Governance Policy Updates and the report of The Conference Board's Task Force on Executive Compensation each discuss controversial pay practices, as do similar pronouncements of other organizations.

  - Consider a dialogue about executive compensation with the main proxy advisory firms and institutional shareholders, particularly in the off-season. In this regard, RiskMetrics and other firms have recognized the potential impact that say-on-pay voting may have. RiskMetrics has indicated that, except in extreme cases, the initial impact of negative conclusions on its voting recommendations will be directed at say-on-pay votes, where they are available, rather than at

director selection. Negative or withhold recommendations for director nominees would only arise in subsequent years. While the legislative outlook for mandatory say-on-pay votes is still uncertain, a minor trend towards voluntary multi-year (either biennial or triennial) say-on-pay voting is emerging. On balance, we believe that continued momentum towards a multi-year approach is desirable as it promotes a more constructive and thoughtful approach to compensation analysis.

- ***Compensation and risk.*** New SEC rules require consideration of whether compensation policies and practices for all employees create risks that are reasonably likely to have a material adverse effect on the company. We believe that this assessment should be based on a careful holistic assessment of the terms and historical operation of relevant plans in the context of the business of a specific company, rather than a formulaic determination that measures risk from a particular perspective – for example, based on historic volatility of payout amount, a probability weighted sensitivity analysis to changes in performance results, or a peer group comparison. These more formulaic approaches can contribute to a robust process and an understanding of the compensation program, but may also in some cases distort compensation decisions insofar as they mask complex judgments about company and individual performance with a sense of measurable certainty.

Director Selection and Succession Planning

The director selection process will change rapidly and markedly in 2010, starting with the 2010 proxy season. New SEC disclosure rules merit board attention,[3] particularly insofar as they prompt reconsideration of board composition and director succession planning, matters that will gain importance with the intersection of majority voting in uncontested director elections, the end of broker discretionary voting in uncontested elections and the likely adoption of SEC rules on proxy access.

- ***Director qualifications and diversity.*** Aside from disclosure about compensation and risk mentioned above, boards should review carefully the new disclosures about director qualifications. These can form one element of a defense by the company of its director selection process and board performance, or a point of attack by activists. While the importance of this disclosure should not be underestimated, puffery should be avoided.

- ***Director succession planning.*** Consideration of the range of experience and qualifications represented on the board may also crystallize board thinking around director succession and competencies that may be underrepresented on the board in light

[3] See our firm's memorandum to clients entitled "SEC Adopts Compensation and Corporate Governance Rule Changes" (Dec. 17, 2009), available at http://www.cgsh.com/sec_adopts_compensation_and_corporate_governance_disclosure_rule_changes/.

of the company's evolution, plans and prospects. SEC rules now also call on companies to disclose whether the board has a policy about diversity and, if so, to describe how it is implemented and monitored. This requirement should also cause boards to consider how they plan for director succession and whether changes to that process or to the board's policies on director qualifications would be appropriate.

- ***Impact of elimination of broker discretionary voting in uncontested director elections.*** Brokers can no longer vote uninstructed shares in uncontested director elections and the impact of this change on 2010 elections is uncertain, especially for companies that have adopted a majority voting standard. Boards, especially boards of companies with a large retail shareholder base, should work with management to ensure that appropriate steps are being taken to "get-out-the-vote" and build support for the company's slate.

- ***Proxy access.*** An enhanced role for shareholders in the director nomination process has been looming since at least 2003 and will not go away. Some have suggested that companies anticipate expected SEC proxy access rules by adopting now proxy access by-laws. In light of the uncertainty over the scope and operation of potential SEC rules and possible Congressional action, we believe that pre-emptive company action would be premature in virtually all cases. The SEC is expected to act sometime in early 2010, which allows ample time for companies to react to the rules in time for the 2011 season, and current Congressional initiatives seem more likely to affirm the SEC's authority in this area than to mandate proxy access. Nevertheless, we believe that boards should be working with management to review potential issues under a proxy access regime, including the information that companies require from director nominees (whether slated by the management or others) and other advance notice requirements. This exercise could include preparation of a draft by-law provision to surface issues applicable to the company's particular circumstances.

- ***Proxy plumbing.*** The SEC has indicated that it will soon address the mechanics of communications and voting under its proxy rules (so-called "proxy plumbing"), although it is not clear whether it will do so through proposed rules or a request of comments as part of a "concept release." Proxy plumbing has attracted significant attention among companies and investor groups, particularly given expectations for more frequent election contests in the future. While interested groups will continue to pursue this topic, we believe that it is premature to expect significant board attention to these matters in 2010.

Board Engagement with Shareholders

Whether and how shareholders can communicate with directors is no longer a mere disclosure matter. The importance and diversity of the few issues we raise in this memorandum highlight the need for engagement with shareholders. As majority voting standards and eventual proxy access rules spotlight board composition and perceptions of board performance, boards and management should be reviewing whether more active shareholder outreach is appropriate and how the board can add value to that initiative. A communications approach that relies exclusively on management is increasingly disfavored, and we agree.

A successful shareholder outreach program should take into account the following questions:

- ***Should the sessions be one-on-one or with a group of shareholders?*** While both approaches may be useful depending on the circumstances, a one-on-one approach will generally lead to more focused and constructive communications.

- ***Which shareholders should be targeted?*** The answer will vary by company. Among the factors to consider are the overall composition of the company's shareholder base, the size and length of an investor's share ownership, the shareholder's previous efforts to engage the company (or other companies) and the nature and number of "hot button" governance issues, such as executive compensation or a staggered board, that the company may be called upon to defend.

- ***Who are the right personnel at the shareholder?*** Institutional shareholders often separate their buy-side decision makers from those responsible for voting. Meetings with both are critical, but should have clearly defined and different goals.

- ***Which director or directors should attend?*** We recommend that one or a very small group of directors be designated. Obvious choices are the "lead" or presiding director or non-executive chairman, as well as the chairs of the nominating / governance and compensation committees. We also recommend that the company's investor relations officer generally be present. Depending on the shareholder's concerns, other participants may be appropriate, such as the general counsel, the head of human resources or the compensation committee's compensation consultant.

- ***What subjects should be discussed?*** We recommend that the goal of shareholder outreach be defined in advance and that companies seek input from shareholders about the agenda to ensure that meetings are constructive. If there are items as to which the company is seeking the shareholder's input, they should be identified to the shareholder in advance for the same reason. Some commentators have expressed concern that shareholder outreach can raise issues under Regulation FD. We believe that prohibiting

or overly restricting shareholder outreach for this reason is an over-reaction to what is a manageable issue.

Preparedness for Increased Merger, LBO and Insurgency Activity

As the era ends (for the time-being) when a company trades at a premium because it hoards cash, and while leveraged financing markets (even for non-investment grade issuers) remain available, we expect cash-rich companies to approach competitors aggressively in pursuit of synergistic mergers and representatives of financial sponsors and their portfolio companies to actively court management teams with LBO visions. We also expect hedge funds to continue to pursue campaigns to oust management they view as weak and to be more frequently pushing boards to explore strategic alternatives, including sales of divisions and the entire company, and return of cash to shareholders. Boards should prepare for this activity by understanding the vulnerabilities in their corporate defense profiles and ways to address them without ruffling proxy advisory firms or important shareholders. Advisable actions often include:

- ***Advance notice by-laws.*** Enhancing advance notice by-laws to eliminate all loopholes (in view of the willingness of courts to interpret ambiguities in these provisions favorably to insurgents) and to assure that any insurgent running a proxy contest must make complete disclosure of all derivative holdings and other material information.

- ***Pill on the shelf.*** Assuring that the board has a rights plan (or "pill") "on the shelf" that the board fully understands and is therefore well-positioned to adopt on short notice should it ever become necessary

Moreover, boards and managements benefit from taking time now to review the appropriate protocol for management to follow should a private equity sponsor contact executives to discuss the benefits of a quick LBO. Finally, the most important step that the board can take to be prepared for approaches by merger counterparties, LBO shops and hedge fund activists – and one that dovetails with the renewed focus on risk discussed at the outset of this memorandum – is to understand thoroughly the company's current long-term plan and why it is the best alternative for the company. Boards should regularly work with management and advisors to assure that they have all the data and explanations necessary to support this conclusion. Should a contest for corporate control ever arise, that same supporting information will be at the center of the battle. It is best to get very comfortable with it now.

The Numbers Still Matter

With so much attention devoted to governance and executive compensation, accounting and other financial reporting matters have been pushed off the front pages. Nothing has occurred, however, to change the axiom that investors and markets are put at significant risk by inaccurate or inadequate financial reporting. Indeed, good accounting and good financial reporting should play an important rule in informing investors of developments and known trends in financial performance and condition and of credit, market, liquidity, capital and other financial risks. It therefore remains critical for audit committees and boards to continue to devote significant attention and resources to accounting and financial reporting and to oversight of the external and internal audit functions. An important element of quality control is continuous improvement – that which is not getting better is often getting worse. Agendas, pre-reads and time for audit committee meetings should not be cut back, nor should the skepticism of a good director be diminished, simply because accounting and financial matters are receiving less public attention.

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