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Selected Issues for Boards of Directors in 2013

In the years since the financial reporting scandals and the Sarbanes-Oxley Act of 2002, and in particular following the financial crisis and the Dodd-Frank Act of 2010, boards of directors have faced greater burdens and more intense scrutiny of their activities and performance. One manifestation of this has been pressure to change the role of directors from one of partnership with and oversight of management to one of an almost quasi-governmental watchdog directly responsible for monitoring management's performance, including its compliance with increasingly complex and burdensome regulation. In addition, activist investors continue to publicly push some boards to pursue strategies focused on short-term returns, even in instances where those strategies are inconsistent with the directors' preferred, sustainable long-term strategies for the corporation.

In recent years, we have advised that directors regularly work with their advisors to monitor and adapt to the continually changing landscape. Among other things, we have suggested more frequent, well-structured engagement with shareholders, a focus on the ability to communicate the corporation's and board's policies in a way that is understandable and convincing to the corporation's constituencies, and that directors prepare to respond to increasing external pressures in a manner that both thoughtfully takes those pressures into account and fully reflects the director's carefully considered view of the long-term interests of the corporation.

In addition to these general points, we also have seen developing during 2012 a series of additional specific issues, discussed below, on which we believe boards of directors and corporations should focus in 2013.

1. Board Composition

We believe that, together with succession planning for management, a crucial issue for many boards of directors is the composition of the board itself. We expect that shareholders will be increasingly focused on the issue of composition, and as a result, in 2013, many boards will need to consider whether the current array of directors is appropriate in light of the evolving business and regulatory environments and the challenges they pose for the corporation.

Of course, continuity of a board's membership is often cited correctly as a desirable element of board composition. However, even in those cases in which changes are desirable, turnover (or expansion of the board through addition of a director) can be slow, and meaningful shifts in composition initiated by the board itself can take years. A board that is not proactive with respect to composition may face short-slate proxy contests that result in significant changes imposed by outside actors who, unlike the board itself, may not be well-suited to make nominations that serve the long-term interests of the corporation.

In the case of changes in composition managed internally by the board, the available approaches are sometimes limited. Many companies have age limits in their board policies, but those limits are sometimes waived, and even if enforced, typically provide only a limited number of board openings over a period of years. Moreover, term limits have not been embraced among U.S. corporations. There certainly are cases of directors voluntarily stepping down or not seeking election at the end of a term, but ordinarily the resulting pace of change is quite slow. A further complication is a growing wariness of many qualified candidates to serve on public company boards in light of the ever-increasing burdens on directors and restrictions certain corporations are imposing on the ability of directors to serve on multiple boards.

In light of these realities, a board and particularly the nominating and governance committee if it has the responsibility, must be thoughtful in assessing characteristics and combinations of characteristics where the board is lacking or not as strong as desired. Candid, and often quite difficult, discussions with existing board members regarding qualifications or even retirement may prove necessary where, giving due regard to the importance of collegiality and continuity, the corporation's and board's interest is nonetheless best served by a change in composition. The size of the board and how it will impact the board's ability to operate effectively is another factor to take into account when considering judicious expansion as a means of improving board composition. In parallel and to facilitate this exercise of evaluating and reacting to board composition, boards should consider drawing up and maintaining a list of potential candidates in light of appropriate skills and experience and the corporation's diversity goals.

2. Executive Compensation Design

The intense focus of recent years on executive compensation will continue into 2013. Given the developments in recent years, directors should regard this state of affairs as unremarkable, and in fact "the new normal" for years to come. However, from one perspective, the beginning of 2013 will represent an important pivot point in the executive compensation debate.

Although the SEC did not promulgate the mandated Dodd-Frank rules on disclosure of "pay for performance" in proxy statements during 2012, the year did bring a few notable related developments. First, corporations, institutional investors, proxy advisory firms, compensation consultants and legal advisors all began to address the question of what is the proper way to measure pay for purposes of assessing whether executive pay properly varied with corporate performance. The shortcomings in the measurement of total compensation as reflected in the Summary Compensation Table mandated under the SEC's proxy rules for that purpose now is widely appreciated, and most participants in the proxy disclosure and annual meeting process recognize the need for an alternative or additional approach. Work on defining an alternative standardized measurement (or measurements), whether it is one of the common conceptions of "realizable pay" or something else, will likely progress substantially in 2013.

Second, the concept of "peer groups" as used in the compensation benchmarking process is undergoing substantial reconsideration on two fronts. The method for selection of peer group members used by proxy advisory firms to run their pay versus performance algorithms has undergone a makeover, resulting in part from disparagement by companies of ISS's old methodology and the development by Equilar and adoption by Glass Lewis of a new model that gives substantial weight to the selections by companies themselves of their peers. Also, academics, led by Charles Elson of the University of Delaware, have questioned the appropriateness of relying primarily on benchmarking against peer groups as a way to set pay, echoing sentiments expressed for years by many directors. While peer group benchmarking will not disappear because it has merit as one factor to consider in the process of setting and assessing compensation, its importance is likely to diminish.

In light of these developments, the challenge for compensation committees, boards of directors, management and the various other participants in the executive compensation process is to improve compensation program design with the goal of being able to convincingly demonstrate that executive pay correlates with management success at achieving long-term strategic and operational corporate objectives. Whether those design improvements are achieved through more or different types of longer-term performance programs, more focus on performance factors other than stock price, more discretion on the part of compensation committee members or other changes in the way senior executives are paid remains to be worked out. We expect this to be a topic of significant focus for boards – and for those who monitor and report on board performance – in 2013.

3. Selling the Company and "Standstill" Agreements

It has been long established that there is "no single blueprint" that directors must follow in connection with selling the corporation and seeking to maximize stockholder value. At least in the absence of a conflict of interest, the courts will defer to the board's good faith business decisions as to how best to seek that highest value: whether through a publicly-announced auction process; through a confidential solicitation of bids from a small (or not so small) number of likely bidders; or through negotiations with one logical bidder followed by either window-shop provisions that make other bids possible or a go-shop process in which the company actually solicits other bids after signing a definitive agreement. What makes sense for the sale of one company, of a particular size in a particular industry at a particular time, may well not be sensible in some other context.

So logically, a board should be able to decide when running a sale process with multiple bidders that the best way to induce the highest bids is to let each bidder know that it needs to put its highest price on the table as part of that process – before it knows who the other bidders are and what price they are willing to pay. In order to accomplish that, the board would need to make sure that each bidder knows that if it loses it will not have another opportunity to raise its bid – and to know that it cannot simply conduct diligence and then hide in the bushes and decide whether to bid and at what price after the "winning" bid has been disclosed (albeit requiring it to pay the inevitable break-up fee, that must not be more than what is reasonable). To induce bidders to play by these rules, a common approach is to require that each bidder agree to the terms of a "standstill" provision contained in the confidentiality agreement that is the price of admission to the diligence process, and for such standstill provisions to prohibit the bidder from requesting a waiver of that standstill, since such a request might vitiate the standstill in view of the directors' fiduciary duties once they receive the request.

A fundamental premise to the validity of a standstill provision containing such a "no waiver requests" clause is that the directors have made a conscious, good faith determination that this is the best approach to obtain the highest price. As noted by the Delaware Chancellor in a bench ruling in a recent case, that logic breaks down if the board is not even aware, in eventually approving a merger agreement containing customary window-shop fiduciary provisions allowing it to react to unsolicited third party bids, that most or all of the other logical bidders are prohibited by their existing standstills from taking advantage of these fiduciary provisions by making a bid or requesting a waiver of that prohibition. Equally important is that the board, with the assistance of company management, keep track of outstanding standstill agreements (including preexisting ones) and be prepared to consider waiving the "don't ask, don't waive" clause if and when appropriate, whether during the solicitation process, prior to entering into a definitive agreement with the winning bidder, or thereafter. This last point is also important, when negotiating a sale transaction with one bidder without exploration of other bids, if there are other logical bidders who previously have signed agreements of any sort containing standstills with "no waiver request" provisions.

The lesson here is the usual one when talking about the sale process. The board needs to be fully informed and actively involved in the sale process throughout. When approving a merger agreement, the board needs to understand fully that agreement's "deal protection" provisions, including any provisions limiting the board's ability to waive standstills, and how the deal protection provisions fit together with existing standstill provisions entered into by other potential bidders, including those who participated in the sales process. Then, the proxy statement (or Schedule 14D-9) seeking stockholder approval should describe the board's process and the deal protection provisions, including any such interaction, for the benefit of the shareholders.

4. Selection of Board Advisors and Conflicts

The past several years have witnessed an increased sensitivity to potential conflicts of interests faced by advisors to boards of directors. Much of this sensitivity has been prompted by recent opinions from the Delaware Court of Chancery criticizing boards for not being sufficiently aware of their advisors' potential conflicts in connection with transactions to sell the company. Further enhancing this sensitivity has been a heightened focus over the last two years by the Court of Chancery on the adequacy of disclosures in merger proxy statements about the potential conflicts of sell-side advisors and a parallel requirement for greater disclosure about conflicts of compensation consultants under new SEC rules applicable to annual meeting proxy statements.

While it continues to be advisable for directors to be keenly aware of any material relationships and activities that an advisor to the board or a committee may have that are relevant to the matters before the board or committee, the degree to which these constitute disabling conflicts remains an area where thoughtfulness, familiarity with the relevant case law, and attention to the details of the context are critical. For example, in the context of a leveraged buyout by a financial sponsor, it is important for the board to use procedures (such as carefully vetting potential conflicts of its financial advisor, appointing a committee of independent directors if warranted or holding executive sessions of the board without management present, and monitoring management's role in interactions with bidders) to assure that the sale process is not tainted. Nonetheless, it very well may be in the best interests of the stockholders for an advisor, with a prior relationship with the company (and, by necessity, with management), to advise the board on the leveraged buyout due to the advisor's familiarity with the company. As a result, selection of an advisor often requires a careful weighing of the various factors by the board to ensure that the interests of the corporation and its stockholders are well-served.

By contrast, in a scenario such as the negotiation of executive officers' employment agreements, it is difficult to envision how a compensation committee could rely exclusively upon advisors that are engaged in or competing for other material assignments where the decision to use these advisors and the terms of their compensation has been or will be dictated by these same executive officers. Indeed, in the compensation context, the requirement to disclose a conflict will often be a disabling factor for a consultant because of the potential impact on the "say on pay" vote. The key to navigating these issues is awareness and common sense deliberation about context.

Accordingly, at the outset of all engagements of advisors, boards ought to consider implementing a review of material interests and relationships of the potential advisory firm and the team leaders so that these matters may be properly vetted. Such a review will effectively be mandated for compensation consultants and other compensation committee advisors by exchange listing rules effective in the summer of 2013. Much of the harsh criticism from the Delaware courts has been prompted not by directors' deciding to engage advisors after duly considering the details of their conflicts, but by the failure to have taken the time, before or early on in the engagement, to become aware of these conflicts and to have deliberated about their nature and what actions, including protocols to limit the impact of conflicts, would be in the best interests of the corporation and its stockholders.

5. Litigation Against Officers and Directors

While the technical details of the litigation environment are generally outside the purview of a board's oversight activities, there have been recent structural changes in the approach taken by the plaintiffs' bar to litigation against corporate fiduciaries such as officers and directors and potential responses by corporations that deserve board attention.

In the past, class action fraud claims under Section 10(b) of the Securities Exchange Act of 1934 arising out of the offering, or trading, of securities were the vehicle of choice. Such claims can only be brought in federal court. Over the last decade, however, there has been an increasing shift to claims under Sections 11 and 12(a)(2) of the Securities Act, with a great effort towards pursuing those claims as class actions in state court. Federal legislation enacted in 1998 was intended to eliminate state court jurisdiction over Securities Act class actions, but the lower courts are in disarray over the meaning of that legislation, and many courts have concluded that state courts are competent to hear such cases – even though state courts have little experience with the federal securities laws. The prospect of conducting high risk proceedings before courts that are less familiar with the terrain creates settlement pressure on corporate defendants that is unrelated to the merits. Unfortunately, under current law the jurisdiction of state courts over Securities Act class actions is determined at the federal District Court level, with virtually no opportunity for review by federal Courts of Appeal. As a result, absent the issue being presented to the U.S. Supreme Court through an appeal from a state court ruling, the disarray and potential increased settlement pressures will continue. Further, Congressional action in this area does not currently appear to be likely.

In addition, the pursuit of corporate officers and directors in state courts with less familiarity with the governing law is now increasingly animating cases that assert non-federal claims. The law of the state of incorporation governs "internal affairs" issues, like the fiduciary duties that officers and directors owe to stockholders. But as cases brought to challenge mergers and acquisitions transactions show, the plaintiffs' venue of choice is increasingly not the courts sitting in the state of incorporation. For example, while for decades the vast majority of cases brought against directors and officers of Delaware corporations, such as in the takeover context, were brought in Delaware, of late, an increasing number are being brought in the state (and federal) courts of the corporation's headquarters. In fact, even more recently, plaintiffs are actively avoiding the Delaware courts altogether even though the subject company is incorporated there. In general, this creates uncertainty in an area in which certainty and predictability are critical to a corporation.

The situation may be exacerbated by a recent development in Delaware requiring stockholder plaintiffs to inspect corporate books and records, as permitted in proceedings under Section 220 of the Delaware General Corporation Law, prior to the filing of claims. While the use of such proceedings enables stockholder plaintiffs to make better decisions about whether to bring suit (and, when suit is brought, to draft more potent pleadings), the time Section 220 actions take enables those filing cases outside of Delaware to do so more quickly, permitting those cases to progress to a stage where they are a *fait accompli*, unable to be dislodged by subsequently filed Delaware cases.

The existing tools for addressing this phenomenon are not terribly effective. Where there are duplicative cases pending in the state of incorporation and in another state court, and neither has progressed too far, the defendants can ask the presiding judges to agree on the state of incorporation as the forum. But both courts need to agree, and the decision is purely a matter of judicial discretion. Where the cases are filed only outside the state of incorporation, there is very little defendants can do.

A potential solution is including a forum selection clause in the corporate charter or bylaws that make the state of incorporation the exclusive forum for suits asserting internal affairs claims. Similar clauses are of course ubiquitous in significant commercial contracts, and their enforceability is not subject to serious doubt. Charters for newly public corporations now often include such provisions, but there has been a mixed reaction, including by proxy advisory services, to company proposals seeking shareholder approval to add such provisions to the certificates of incorporation or bylaws of existing public companies. Some of the skepticism may be the result of efforts to adopt forum selection provisions through bylaw amendments adopted only by the board of directors. In at least one case, a court found such a bylaw invalid, likely because the bylaw was adopted after the events that gave rise to the lawsuit had occurred, and the amendment may have appeared to constitute an unfair forum shopping effort by the defendants.

The general validity of forum selection clauses in bylaws is currently the subject of litigation in Delaware. Whatever the outcome, there is reason to believe that the correct answer is that such a bylaw not applied retroactively should be valid. In addition, there appears little doubt that a forum selection provision added to a certificate of incorporation, which requires board and shareholder approval, is enforceable. However, the question remains whether corporations and their boards can make a convincing case before shareholders and the proxy advisory services regarding the benefits of such a provision in promoting predictability in litigation and restricting forum shopping that undermines predictability.

6. <u>Dual Fiduciaries</u>

Corporations and boards should be mindful of potential dual fiduciary scenarios – i.e., situations in which an officer or director of a company has a position at another entity that gives rise to fiduciary duties that may conflict with his or her duties to the first company. Among the factors that contribute to the likelihood of these scenarios arising are:

- Expansion of businesses and convergence of sectors, including as a result of the adoption of technologies by the corporation or on a sector-wide basis that may give rise to the corporation's competing with one or more entities that had not formerly been competitors;

- Presence on the boards of the corporation of representatives of private equity or hedge funds that may have other investments in the same sector;

- Presence of representatives of, or directors or officers from, the corporation on the boards of private entities that turn out to be pursuing operations that overlap with those of the corporation; and

- Presence of officers or directors of a parent corporation on the boards of newly spun-off entities.

These (and other similar) scenarios risk giving rise to:

- Violations of the corporate opportunity doctrine;

- Violations or compliance issues under antitrust laws;

- Violations of other regulatory requirements regarding interlocking directors, for example relating to financial institutions or public utility holding companies; and

- Seemingly irreconcilable clashes between duties of candor to one entity and duties of confidentiality to another.

In addition, certain of these scenarios may raise significant issues under the applicable state corporation law's duty of loyalty such that the board risks losing the protection of the business judgment rule in connection with a particular decision.

Fortunately, if identified in advance of board activities where these conflicts are implicated, these risks are usually manageable through the adoption of context-based protocols that either take advantage of safe harbors provided under applicable law or set forth procedures that assure that preemptive actions, such as exclusion from both receipt of certain materials and participation in certain deliberations, insulate the directors and their corporations from problematic situations. These protocols strive to assure that the corporation's confidential information is treated properly and that the board is able to maximize its ability to reap the benefits of the advice and assistance of a director with other interests and relationships.

In most situations these solutions may be implemented only if in-house counsel, management and directors are aware of the scope and nature of the outside activities of their officers and directors and regularly evaluate them for overlap with the content of board materials and meetings and the actual and prospective activities of the corporation. The timeliness of awareness of potential conflicts and implementation of protocols is critical. Not all scenarios may be cleansed effectively through adjustments to process if the dual fiduciary scenario is identified too late. Possible practical steps to evaluate, and when necessary, address these issues include notification requirements to in-house counsel and nominating and governance committees by directors and officers when they take on new positions or their responsibilities change and periodic refreshing of D&O questionnaires regarding conflicts information.

7. Developments of Interest to Audit Committees

Prompted by expressed investor concerns, the Public Company Accounting Oversight Board, or PCAOB, has been active recently in the areas of increased communications between audit committees and independent auditors and by auditors directly with investors.

First, the PCAOB adopted, and the SEC has now approved, a new audit standard (Standard No. 16) that will be effective for 2013 and that provides for expanded required communications between external auditors and the audit committee. In many respects, the new standard only maintains requirements already in effect, but it does increase the focus on such communications and add or enhance some requirements.

Some of the prior accounting literature has suggested that communications between an auditor and audit committee are incidental to the audit process. In adopting Standard No. 16, however, the PCAOB emphasized that these communications are an important element of the audit process for the auditor and important to the understanding of the audit for the audit committee. As a result, these communications must now take place before the audit report is issued. In addition, the PCAOB emphasized the utility of robust two-way substantive dialogue between auditors and audit committees, rather than check-the-box boilerplate reports by auditors. Importantly, Standard No. 16 does not require that communications be in writing, and while written reports will of course still be an important element of meeting the Standard, this fact should help foster meaningful dialogue.

Among the more significant required communications on which audit committees might focus are the following:

- communications by the auditor regarding the quality of a company’s financial reporting, including disclosure regarding critical accounting policies and identified bias in managements judgments;

- identification of other persons, if any, not employed by the auditor performing audit procedures; and

- communications regarding significant unusual transactions (not limited to related party transactions) and the business rationale therefor as understood by the auditor.

The PCAOB points out that Standard No. 16 does not address, and should not affect, the communications between management and audit committees. Such communication is of course part of the foundation of effective audit committee performance, and we emphasize that nothing in Standard No. 16 should be taken as a contrary signal. Indeed, Standard No. 16 notes that an element of required auditor-audit committee communications involves auditor inquiries of the audit committee regarding matters relevant to the audit, including, but not limited to, violations or possible violations of laws or regulations. Comprehensive communications between management and the audit committee, including an understanding by the audit committee of management's communications and interactions with the auditors, are an essential predicate for such inquiries.

Beyond Standard No. 16, the PCAOB in 2011 issued concept releases regarding the form and content of reporting by auditors and regarding auditor rotation which the PCAOB will continue to consider in 2013. While the PCAOB perceives significant investor interest in more communications directly by auditors, it appears that it will not move towards *de novo* disclosure by auditors including, at the extreme, an alternative "auditor's discussion and analysis" of a company's operations and financial condition that would supplement or complement (or in the view of critics compete with) management's discussion and analysis. There appears to be more continued interest in using the audit report to associate the auditor incrementally with financial reporting, for example by increasing use of "emphasis paragraphs" in the audit report that would highlight particular aspects of a company's financial reporting.

Finally, the concept of mandatory auditor rotation continues to be considered by the PCAOB, despite substantial opposition from auditors and companies, largely on the grounds that audit quality would likely suffer. International developments, including adoption of a mandatory "rebidding" rule in the UK for the largest companies and possible adoption of some version of mandatory rotation in the EU, are providing part of the impetus for the PCAOB's ongoing consideration. The PCAOB is also evaluating whether there are other approaches, to its and investors' concerns regarding "capture" and resulting lack of skepticism on the part of long-time auditors, that do not raise the same issues as rotation regarding damage to audit quality. Decisions in this area do not appear to be imminent, but given the significant impact auditor rotation could have, audit committees should continue to be aware of developments.

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Although 2013 promises continued challenges for directors, we believe them manageable with attention to sound principles of governance and mindfulness of the evolving business and regulatory environments. We of course stand ready to discuss any of these issues with you and invite you to contact any of the Cleary Gottlieb lawyers with whom you work or any of the partners or counsel listed under Capital Markets, Corporate Governance, Executive Compensation and ERISA, Litigation and Arbitration, or Mergers, Acquisitions and Joint Ventures in the "Practices" section of our website at http://www.clearygottlieb.com.

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