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Corporate Governance in 2009
"Change You Can Believe In"

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Introduction

- We are at a tipping point that will result in new legislation
- Congress, the SEC and Delaware courts are all hard at work
- Moving from a Director Centric Model to a Shareholder Centric Model

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Introduction

- Shareholder Bill of Rights Act of 2009
  - Annual advisory vote on executive compensation
  - Shareholder approval for executive golden parachutes
  - Proxy Access
  - Directors subject to annual shareholder votes (no staggered boards)
  - Majority voting for directors
  - Separate duties of CEO and COB
  - Create separate board risk Committees

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"The role of state law is going to be determined by the federal government in the next several months to a year. I almost equate it to the Frankenstein movie with the villagers with pitchforks. It's a populist frenzy. The absence of thoughtful approach in a time of crisis is what frightens me more than anything else."

- Myron Steele, Chief Justice of Delaware's Supreme Court

Topics for Today

- Proxy Access
- Rule 452: Broker Discretionary Voting
- Other SEC Disclosure Proposals Relating to Governance
- Developments in Director Fiduciary Duty

Proxy Access

- Proxy access is the concept of giving shareholders the ability to require that their nominees for directors are included into the company's proxy statement alongside the nominees recommended by the company's board.
- Hotly Debated:
  - Shareholder groups favor proxy access because it reduces the cost of proxy contests
  - Business groups oppose it for the same reasons, it allows activists to challenge the incumbents for little cost and no meaningful risk
- Regulated by:
  - State corporate law
  - SEC

Proxy Access: Delaware Regulation

- Amended state's corporation law to expressly provide for by-laws that require that a company:
  - Include shareholder nominees for board seats in its proxy statement, and
  - Reimburse shareholders for the cost of successful proxy contests

Proxy Access: Delaware Regulation

- By-law requirements for proxy access may include provisions that:
  - Require minimum record or beneficial ownership (which may include options, derivatives, or voting rights), or duration of ownership
  - Preclude nominations by any person who has acquired shares constituting a specified percentage of the voting power of the corporation's outstanding stock
  - Require nominating stockholder to submit specified information about the stockholder and its nominees
  - Condition eligibility upon the number or proportion of directors nominated by stockholders or whether the stockholder previously sought to require such inclusion
  - Require nominating stockholder to indemnify the corporation for any loss arising as a result of any false or misleading information submitted in connection with a nomination
  - Prescribe any other lawful condition to the exercise of proxy access

Proxy Access: Delaware Regulation

- By-law provisions for proxy expense reimbursement may include provisions that:
  - Condition eligibility for reimbursement on the number of proportion of persons nominated by the stockholder seeking reimbursement, or whether the stockholder previously sought reimbursement for similar expenses
  - Limit the amount of reimbursement based on the proportion of votes cast in favor of one or more persons nominated by the stockholder seeking reimbursement, or upon the amount spent by the corporation in soliciting the proxies in connection with the election
  - Proscribe limitations concerning elections of directors by cumulative voting
  - Include any other lawful condition

Proxy Access: SEC Regulation

- First examined and rejected by SEC in 1942
- In 2007, the SEC considered proxy access for shareholders who owned at least 5% of a company's stock
- Mary Schapiro, the current chairman of the SEC, has endorsed proxy access

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Proxy Access: SEC Regulation

- SEC could propose a proxy access rule by mid-May
- It is weighing three options:
  - Allow certain shareholders to directly nominate directors on corporate ballots, if certain conditions are met
  - Let those shareholders submit proposals, that if approved, would allow them to nominate directors
  - Combinations of the two alternatives above
- Also considering a sliding scale, based on company size, for minimum ownership eligibility threshold

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Rule 452: Broker Discretionary Voting

- 70-80% of U.S. company shares are held in “street name”
- If the beneficial owners do not provide voting instructions within 10 days of company meeting brokers can vote their shares on routine matters, including uncontested elections
- Those votes are overwhelmingly cast for management nominees
- The Wall Street Journal reported that as of January 1, 2010 brokers will no longer be entitled to vote the shares by their customers who fail to vote for uncontested directors.

Rule 452: Broker Discretionary Voting

- Arguments in favor of Rule 452 amendment:
  - The Rule impairs accountability of directors
  - Discretionary broker voting can blunt the effect of "vote no campaigns"
  - Proportional voting contravenes one share / one vote principle

Rule 452: Broker Discretionary Voting

- Arguments against Rule 452 amendment:
  - More difficult for smaller companies to meet quorum requirements
  - Increased cost of board elections
  - Disenfranchise individual investors
  - New administrative burdens
  - Elimination of broker votes would destabilize the proxy voting system by giving a disproportionate amount of weight to institutional investors
  - Corporate secretaries contend that discretionary broker voting accurately reflects sentiments of retail investors
  - Rule change forecloses alternatives such as proportional voting

Other SEC Disclosure Proposals Relating to Governance

- Director Qualifications:
  - Currently rules only require a brief description of a director nominee's business experience over the past five years
  - In June 2009 the SEC will consider additional disclosure of director nominee's experience, qualification and skills
- Leadership Structure:
  - SEC is debating whether boards should disclose their reasons for choosing particular leadership structure
  - Independent chair, non-independent chair, or a combined CEO/chair
- Risk Management:
  - SEC is considering requiring more comprehensive disclosure about risk management
- Compensation Disclosure:
  - SEC is considering additional compensation disclosure regarding:
    - The company's overall compensation approach beyond highest paid executives
    - Compensation consultants' conflict of interest
    - How comp plans designs relate to longer-term performance
    - Benchmarking and comparing pay practices to competitors
    - Changing the formula used in the proxy statement summary compensation table for valuing stock options and stock awards, which are criticized for low balling reported compensation values

Director Fiduciary Duty

- Duty of Care
  - Care in overseeing the corporation's business
  - Care in making specific business decisions
- Duty of Loyalty
  - Interest of the corporation ahead of the individual's interest

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Director Fiduciary Duty

- Section 102(b)7 of the DGCL allows for certificates of incorporation to exculpate directors from liability for breaches of duties of care, but <u>not</u> for breaches of duty of loyalty and acts of bad faith
- Important cases:
  - <u>Citigroup</u> – duty to monitor / corporate waste
    - <u>Caremark</u> – duty to monitor
    - <u>Stone v. Ritter</u> – duty to monitor
  - <u>Lyondell Chemical Company v. Ryan</u> – duty of loyalty due to failure to act in good faith

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Director Fiduciary Duty

- <u>Caremark</u>:
  - Established that a director's duty of care includes taking steps to insure the corporation has competency to detect and prevent illegal activity
  - "It is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operation, so that it may satisfy its responsibility."
  - When alleging a lack of oversight the plaintiff must show that the directors demonstrated a "sustained or systematic failure" to exercise oversight, through, for instance, an "*utter failure* (emphasis added) to attempt to assure that a reasonable information and reporting system exists."

Director Fiduciary Duty

- Stone v. Ritter:
  - "Caremark articulates the necessary conditions predicate for director oversight liability: (a) the directors *utterly failed* (emphasis added) to implement any reporting or information system or controls; or (b) having implemented such a system or controls, *consciously failed* (emphasis added) to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."
  - Held that in absence of "red flags," liability will arise only in the presence of a "sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists." (quoting Caremark)

Director Fiduciary Duty

- In re Citigroup Shareholder Derivative Litigation:
  - Dismissed claims against directors for breach of fiduciary duties due to failure to monitor subprime market risk exposure
  - The court allowed a claim relating to the CEO's $68 severance package under the theory of corporate waste
  - To overcome the business judgment rule in the context of a claim for corporate waste, the court analyzed "whether there was an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any person might be willing to trade."
  - Plaintiff "must allege particularized facts that lead to a reasonable inference that the… defendants authorized an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."
  - "[T]here is an outer limit to the board's discretion to set executive compensation, at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."

Director Fiduciary Duty

- In re Walt Disney Derivative Litigation:
  - The court found that directors were protected by the business judgment rule and did not violate their fiduciary duty in connection with the hiring and subsequent termination of the company's CEO, Mr. Ovitz, notwithstanding a no fault severance package of $130 million after 14 months of work
  - "A claim of waste will arise only in the rare, 'unconscionable case where the directors unconscionably squander or give away corporate assets'"

Director Fiduciary Duty

- Lyondell Chemical Company v. Ryan:
  - Directors breach their duty of loyalty by failing to act in good faith "only if they knowingly and completely failed to undertake their responsibilities…"
  - "Instead of questioning whether disinterested, independent directors did everything that they should have done to obtain the best sale price, the inquiry should have been whether those directors *utterly failed* to attempt to obtain the best sale price."
  - Citing Disney: "bad faith will be found if a fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."

Conclusion

- What to do?
  - Discuss and prepare for the changes
  - Wait until new federal legislation and SEC rules are enacted
  - Evaluate how our companies wish to address the new issues