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Inside

A publication of the Corporate Counsel Section
of the New York State Bar Association

Message from the Chair

We're bringing to a close another active and productive year for the Corporate Counsel Section.

As ever, our activities have been informed by our membership, whose breadth of interests and practice areas gives us both the challenge and the tantalizing opportunity to create programs and content stretching across the legal spectrum.

This year the Section offered and co-sponsored substantive programs on a variety of topics and reached out to new members via NYSBA events such as the July summer Boat Cruise in New York Harbor (see photo inset). Despite a challenging economy in which budgets are tighter than ever and dues perhaps harder to find, the Section continues not only to retain a solid core membership, but to attract new members. We appreciate the vote of confidence and we will continue to earn it through strong and dynamic programs.

Our Kenneth Standard Diversity Internship Program continues to shine, and Section members now join us at the annual reception honoring a growing legacy of interns and corporate hosts past, present, and future.

Our third Corporate Counsel Institute once again offered answers to some of the most complex topics facing attorneys today. Panels and breakout sessions chaired by leading practitioners gave participants a forum to learn and discuss how changes ranging from technology to the political climate have altered our responsibilities as corporate counselors.

Inside

Editors: Janice Handler and Allison B. Tomlinson

Special Issue: Corporate Governance

NYSBA

This year also saw the establishment of our new Technology Subcommittee, chaired by Julie Ko. This subcommittee will work to strengthen our accessibility to and interaction with members via new initiatives such as Webinars, Webcasting and / or podcasting existing programs, e-distribution of publications and other materials, and enhancement of the Section Web site.

Corporate Counsel at the NYSBA Membership Cruise
(l to r) Fawn Horvath, Eric McCormick, Wayne McNulty, Tom Reed, David Rothenberg

At the Annual Meeting I'll be turning over the reins to Allison Tomlinson, whose hard work on this publication and leadership of the Strategic Planning Subcommittee has already shown her to be well-qualified for the job. I'm confident that under her leadership the Section will continue to be a dynamic resource for counsel to meet and learn from each other, to share ideas and provide the network and resources members need to tackle each change to the corporate legal landscape.

Please join me in welcoming Allison, and also in sending thanks to Section friend and partner Terry Brooks. Terry, who has been the NYSBA liaison to this Section since its founding in 1981, retired in November. All of us on the Executive Committee have benefited greatly from his guidance; on behalf of the Section, we thank him and wish him the best.

Fawn M. Horvath

SAVE THE DATE

for our

Annual Meeting Program

on

Career Planning for Corporate Counsel

Wednesday, January 27 at 9:00 A.M

Hilton New York

Attendees will learn strategies to plan and guide their careers as in-house counsel by exploring topics including career management, working with recruiters, compensation trends, and employment and ethical issues in the transition between law firm and in-house practice.

Register online at www.nysba.org/AM2010

New Signposts and Practical Pointers for Directors in Troubled Times

By Morgan Walbridge and Dennis J. White

The current economic distress has put immense pressure on corporate boards of directors to consider and address the financial and operational challenges faced by their companies. Moreover, directors are often forced to weigh difficult choices among alternatives that are less than optimal, all under tight time constraints and under heightened scrutiny by shareholders and other stakeholders. This high-stakes environment has generated a recent series of judicial decisions that focus on directors' fiduciary obligations and provide guidance on how directors should conduct themselves in these difficult times. Examination of these cases also yields practical pointers on how corporate counsel can advise directors so as to reduce their risk of personal liability.

Duty of Oversight: Monitoring Business Risk vs. Fraudulent or Unlawful Activity

In distressed times, companies are more apt to suffer financial losses and experience other difficulties. When a company experiences significant adversity, it is not unusual for a group of shareholders to bring allegations that the blame should be borne by the directors for having breached one or more of their fiduciary duties.

One such duty, the duty of oversight, was recently discussed by the Delaware Court of Chancery in a derivative suit brought against current and former directors of Citigroup. The suit alleged that the directors breached their fiduciary duty of loyalty for "(1) failing to adequately oversee and manage Citigroup's exposure to problems in the subprime mortgage market, even in the face of alleged 'red flags' and (2) failing to ensure that the Company's financial reporting and other disclosures were thorough and accurate."[1] The "red flags" alleged by the plaintiffs were largely in the public domain (including news articles and credit agency ratings) and reflected worsening economic conditions, a continuing decline in the subprime and credit markets, and the resulting impact on financial institutions.

Typically, boards of directors are protected in exercising their duties by the so-called business judgment rule. The business judgment rule insulates directors from liability relating to their duty of care so long as they act on an informed basis, in good faith, and in the honest belief that their actions are in the company's best interests.

In bringing their claim, however, the *Citigroup* plaintiffs relied on *Caremark Int'l Inc. Derivative Litigation*[2] and its progeny which clarified a director's "duty of oversight." While the court in *Caremark* interpreted the duty of oversight broadly, requiring directors to ensure that an adequate corporate information and reporting system exists, the court also indicated that "where a claim of directorial liability for corporate loss is predicated upon ignorance of liability…only a sustained or systemic failure of the board to exercise oversight…will establish the lack of good faith that is a necessary condition to liability."[3] The *Caremark* standard for directors was later affirmed in 2006 in *Stone v. Ritter*[4] in which the Delaware Supreme Court further clarified that a showing of bad faith is an essential element in proving oversight liability. As the Delaware Supreme Court further explained in *Stone*: "Where directors fail to act in the face of a known duty to act thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith."[5]

> *"This high-stakes environment has generated a recent series of judicial decisions that focus on directors' fiduciary obligations and provide guidance on how directors should conduct themselves in these difficult times."*

In applying the learning of *Caremark* and *Stone*, the Delaware Court of Chancery in Citigroup found for the directors and refused to permit the case to proceed. The court labeled the suit as one that "essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to recognize the risk posed by subprime securities."[6] The court noted that Citigroup had in fact established procedures and controls to monitor risk, including the establishment of an audit and risk management committee. The court focused on the extremely high burden that the plaintiffs carried in order to rebut the presumption that the directors acted in good faith and cited Chancellor Allen's observation in *Caremark* that "director liability based on the duty of oversight is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[7] The court found that the plaintiffs had failed to plead particularized facts demonstrating that the directors acted in bad faith and consciously disregarded their fiduciary duties.[8] The opinion noted that failing to dismiss the plaintiff's claim would risk undermining well settled policy of Delaware law by placing courts in the position of essentially second guessing directors' business decisions.[9]

> *"In these distressed times, boards are more frequently facing the difficult question of whether a distress sale of the business is the only option reasonably available, except for outright liquidation."*

In finding for the defendants, the Chancery Court essentially ruled that *Citigroup* was not a *Caremark* type case. Apart from finding no evidence of bad faith, the court observed that "significant differences exist between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk."[10] In fact, in the same month as *Citigroup*, another judge on the Chancery Court allowed a "failure to monitor" claim to survive a motion to dismiss. In that case, the Chancery Court cited well-pled allegations of pervasive, diverse and substantial financial fraud and allowed the suit to proceed.[11]

Board Duties in a Sales Transaction

In these distressed times, boards are more frequently facing the difficult question of whether a distress sale of the business is the only option reasonably available, except for outright liquidation. For example, private equity firms typically lack resources adequate to allow them to support all their troubled portfolio companies. Their principals must decide which companies they will support, which they will sell and which they will abandon. Also, sales in a down market will result in reduced purchase prices which may prompt stockholders and creditors to question whether a particular sale was at fair value. Against this backdrop, several recent cases have addressed the duties of directors in sales transactions.

(a) Fiduciary Duties to the Common vs. the Preferred Holders

The decision by the Delaware Court of Chancery in *In re Trados Shareholder Incorporated Litigation*[12] makes it clear that, in considering any change in control transaction, directors, particularly private equity-appointed directors, must take care not to favor the interests of the preferred stockholders where they diverge from the interests of the common holders.

In re Trados involved the sale of a company in a transaction where Trados' preferred stockholders received $57.9 million to satisfy most of their liquidation preference, management received $7.8 million in incentive compensation and the common stockholders received nothing. Certain Trados common stockholders brought an action for breach of fiduciary duty, alleging the directors favored the interests of the preferred stockholders either at the expense of, or without considering, the common stockholders. The plaintiffs asked why the company, which was meeting its financial plan, had to be sold at the point in time chosen by the board.

The Court of Chancery refused to dismiss plaintiff's fiduciary duty claims. The court cited prior case law holding that directors owe fiduciary duties to preferred where the right claimed by the preferred is a right shared equally with the common. Where this is not the case, the court held it is the board's duty to favor the interests of the common stock. Because the interests of the preferred and the common stockholders clearly diverged with respect to a sale (most notably since the common would receive zero consideration from the sale), the court held that plaintiffs could avoid dismissal if there were reasonable facts to demonstrate that directors lacked independence. The court then found that appointment of four directors to the board by private equity firms with major holdings of the preferred stock, the employment or ownership relationship between such directors and firms, and the fact that another director was the CEO with a bonus tied to the sale price were sufficient to support a reasonable inference that such directors had a personal interest in the sale decision, thereby rebutting the presumption of the business judgment rule. The court did not make a final determination of liability, but it did allow the case to move forward.

(b) Recent Interpretation of *Revlon* Duties

In sales transactions during distressed times, directors should be especially cognizant of their duties first established by the landmark case of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[13] The *Revlon* ruling, issued in 1986, requires directors in a change-in-control transaction to maximize the value of the company and secure the best available price for the stockholders under the circumstances. In March of this year, the Delaware Supreme Court issued its opinion in *Ryan v. Lyondell Chemical Co.*[14] which provides clarification as to the extent and triggering of such duties.

In *Lyondell*, stockholders brought an action claiming that the board's hasty approval of the company's sale breached the board's *Revlon* duties. The Delaware Court of Chancery denied the defendant directors' motion for summary judgment, noting that the deal had been approved in less than seven days and that the board had performed no market check and also agreed to substantial deal protections for the buyer. Applying the precedent set forth in *Stone* that the fiduciary duty of loyalty is breached where the board demonstrates "a conscious disregard for their responsibilities" and a failure "to discharge that fiduciary obligation in good faith,"[15] Vice Chancellor Noble was troubled by the above noted aspects of the sales process and refused to grant the directors summary judgment.

In March, however, the Delaware Supreme Court unanimously reversed the lower court's ruling. The opinion of the Delaware Supreme Court found that although the Delaware Chancery Court had properly stated the principle that bad faith and a breach of loyalty can be based on a conscious disregard of a known duty, the lower court erred in the following respects: (1) finding *Revlon* duties applied even before the directors had decided to sell the company, (2) requiring a specific process to satisfy *Revlon* duties, and (3) by "equat[ing] an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith."[16]

The decision of the Delaware Supreme Court is especially helpful to directors in its clarification of two points: (i) that *Revlon* duties arise only when a company "embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control"[17] and not simply because a potential acquirer has indicated interest in pursuing an acquisition; and (ii) there is "no single blueprint" for how a board must discharge its *Revlon* duties.[18] The court recognized that each transaction poses a unique set of circumstances that may require different means to satisfy the directors' fiduciary obligations. The ruling evidences the Delaware Supreme Court's deference to the business decisions of boards in the context of a *Revlon* transaction, at least when such decisions are judged under the duty of loyalty and good faith standard.

Practical Implications and Pointers

In addition to clarifying and refining legal principles regarding director liability, these recent Delaware cases, upon further examination, are also a source of some practical pointers on how corporate counsel can help reduce the risk of personal liability for directors through appropriate advice and specific preventative measures, including the following:

1. Establish Appropriate Oversight Policies and Procedures

The board should confirm that appropriate oversight policies and procedures have been established and that active monitoring is taking place. Such policies and procedures should be re-evaluated periodically to ensure that they are responsive not only to external and operational risks, but also to the threat of potential fraud or violations of law by management or employees. For example, the court in *Citigroup* gave great weight to the fact that the board had established an active audit and risk management committee to help assess the risk related to mortgage-backed securities.

2. Review the Scope of Indemnification Coverage

In both *Citigroup* and *Lyondell*, the companies had elective language in their charters pursuant to Section 102(b)(7) of the Delaware General Corporation Law that exculpated the directors from personal liability for breach of their fiduciary duties except for breaches of the duty of loyalty or actions or omissions not in good faith or that involved intentional misconduct or knowing violations of law. Corporate counsel should confirm the board is fully protected to the full extent allowed under the applicable law. Absent such provisions, director actions would typically be judged under the duty of care, a higher standard. Since D&O insurance policies are far from standard, corporate counsel should also have the company's D&O policy reviewed by an expert to ensure that the coverage for the individual directors and officers is adequate and that the appropriate endorsements have been secured. In particular, it is possible to purchase separately a Side A policy that covers only the directors or non-company directors and helps avoid depletion of coverage resulting from claims against the company and delay of payments in a company bankruptcy.

3. Be Watchful of Situations Involving Director Self-Interest

Even an exculpatory charter provision does not afford protection where the director acts out of self-interest. In such situations, a director's good faith is called into question and he or she no longer enjoys the presumption of the business judgment rule. In such situations, a director should absent himself or herself from deliberations where the matter in question is being discussed or decided so as not to taint the decision-making process and compromise the independence of the other directors. In certain cases it may be appropriate to appoint a special committee of independent directors to address a particular transaction or matter to ensure the business judgment rule still applies.

4. Anticipate Litigation and Avoid Non-Privileged Communications

Directors should be counseled that if suit is brought, all communications among the board members and with management will be subject to discovery. In the *In re Trados* case, several e-mails among the private equity-designated board members were quoted in the court's opinion as possible evidence of self-interest in selling the company. Handwritten notes and e-mails (even "deleted" e-mails) can come back to haunt their creators. If litigation is anticipated, corporate counsel should issue a document preservation directive. Withholding or destroying materials can result in liability or a claim of spoliation with an adverse inference against the company or the directors.

5. Follow a Deliberative Board Process and Document Its Implementation

While director exculpation provisions have generally been upheld, directors would nonetheless be prudent to fully discharge their duty of care. In that regard, process is key. The board should be well informed and briefed by management. However, the board should also feel free to conduct its own analysis, ask questions and consult with legal and financial advisors on whom it may rely. It is important that directors take the time to make an informed decision. Finally, the board minutes should reflect such deliberations.

6. Be Mindful of *Revlon* Duties in a Sale Transaction

In a proposed sale transaction, the board should discharge its *Revlon* duties to secure the best available price under the circumstances. The board should also discuss and consider the impact of the sale on all classes of equity, and if the company is insolvent or in the zone of insolvency, upon the creditors.

7. Counsel the Board Regarding Its Duties

Corporate counsel should, on a regular periodic basis, counsel the board members regarding their fiduciary duties, and provide a refresher briefing when the board is faced with a potential sale or other matter that might attract litigation. Document in the minutes, or elsewhere, that the board has been so briefed and is aware of its duties. If suit is then brought, counsel to the directors can then demonstrate to the court that they understood their duties.

Endnotes

1. *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d. 106, 114 (Del. Ch. 2009).
2. 698 A.2d 959 (Del. Ch. 1996).
3. *Id.* at 971.
4. 911 A.2d. 362 (Del. 2006).
5. *Id.* at 370.
6. *Citigroup*, 964 A.2d. at 124.
7. *Id.* at 125 (quoting *Caremark*, 698 A.2d at 967).
8. *Id.* at 127.
9. *Id.* at 126.
10. *Citigroup*, 964 A.2d. at 131.
11. *American International Group, Inc. Consolidated Derivative Litigation*, 2009 WL 366613 (Del. Ch. Feb. 10, 2009).
12. Civil Action No. 1512-CC (Del. Ch. 2009).
13. 506 A.2d 173 (De. 1986).
14. 970 A.2d 235.
15. 2008 Del. Ch. LEXIS 105 (quoting *Stone*, 911 A.2d. 362 at 370).
16. *Lyondell*, 970 A.2d. at 241.
17. *Id.* at 242.
18. *Id.* at 242–243 (quoting *Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279, 1286 (Del. 1989)).

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Losses, But No Liability, for the Failure to Monitor Business Risk

By Donald A. Corbett and Daniel Roque

A failure to monitor business risk may not be good for business, but in the eyes of the law it beats a failure to monitor legal risk.

Citigroup and AIG have both been laid low by the credit crisis, generating critical headlines, requiring federal bailouts, and inspiring talk of a new wave of regulation. Citigroup directors recently escaped liability when two influential courts dismissed shareholder derivative claims based on the directors' alleged failure to monitor the business-risk profile of the company.

In contrast, AIG directors were unable—at least at the pleading stage—to escape shareholder derivative claims for their role in the crisis. The critical difference is that the claims against AIG were *not* predicated on allegations that the directors failed to monitor business risk, but that AIG directors and officers failed to adequately monitor legal risk, i.e., the monitoring of compliance with governing law, rules, and regulations.

Background—Duty to Monitor

While directors are charged with the obligation to manage the affairs of a corporation, the actual day-to-day management of the corporation is typically delegated to corporate officers.[1] Nevertheless, directors' oversight responsibility dictates that they have in place systems and controls to monitor the corporation's compliance with applicable laws, rules, and regulations. Although historically the province of state law,[2] federal law and regulations[3] are playing an ever increasing role in director responsibilities, as are private entities, such as the stock exchanges and rating agencies.[4] The potential consequences for breaching these obligations: liability for the corporation and personal financial liability for the director.

The Delaware Chancery Court was the first court to articulate a director's and board's duty of oversight in *In re Caremark International Inc. Derivative Litigation*.[5] Plaintiffs' claims in *Caremark* were predicated on the allegation that the directors had failed to monitor Caremark's operations, i.e., liability premised on "unconsidered inaction," as opposed to an affirmative board decision to act or not act. The court explained that the duty to monitor includes the board's ability "[to] assur[e itself] that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance."[6]

> *"The critical difference is that the claims against AIG were* not *predicated on allegations that the directors failed to monitor business risk, but that AIG directors and officers failed to adequately monitor legal risk, i.e., the monitoring of compliance with governing law, rules, and regulations."*

The court set a high standard for imposing liability on a failure-to-monitor theory: "[O]nly 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—will establish the lack of good faith that is a necessary condition to liability."[7]

The Delaware Supreme Court later approved of the *Caremark* oversight liability standard and explained that "oversight" liability is characterized by a lack of good faith.[8] The court ruled that "*Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls, *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[9] In both cases liability is predicated on a "showing that the directors knew that they were not discharging their fiduciary obligations."[10]

Dispelling any notion that the duty to monitor would apply only to directors, the Delaware Supreme Court has also recently confirmed that directors' and officers' duties of care and loyalty are identical.[11]

No Violation of the Duty to Monitor

Two influential courts, the Delaware Chancery Court and the United States District Court for the Southern District of New York, recently declined to impose *Caremark* liability for a failure to monitor business risk, as opposed to a failure to monitor for wrongdoing or illegal conduct.[12]

In *In re Citigroup Inc. Shareholder Derivative Litigation*, the Delaware Chancery Court rejected the plaintiff's attempt to hold directors liable for their failure to monitor business risks associated with the bank's exposure to the subprime mortgage market.[13] The court, hostile at times to such an argument, refused to extend *Caremark* liability to the purported failure to monitor business risks: "While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different."[14]

> *"Directors who engage in significant wrongdoing, such that their activity resembles a 'criminal operation,' will be liable under a* Caremark *theory of failure to monitor because their involvement in the wrongdoing demonstrates that they knew the company's internal controls were inadequate and could be easily bypassed."*

Companies, the court noted, are in the business of balancing risk and return. Courts are not. "To impose oversight liability on the directors for failure to monitor 'excessive' risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors…to personal liability for failure to predict the future and to properly evaluate business risk."[15] The court noted that taking plaintiff's theory to its logical conclusion would mean that defendants could be found similarly liable for their failure to predict the subprime mortgage meltdown and profit from it.[16] The court ultimately dismissed the *Caremark* counts, finding that the derivative plaintiff had failed to establish the extremely high burden of showing bad faith—the necessary element to establish that directors "*knew* they were not discharging their fiduciary obligations or that the directors demonstrated a *conscious* disregard for their responsibilities such as by failing to act in the face of a known duty to act."[17]

The court cited a number of factors in support of its decision. For instance, Citigroup had a number of procedures and controls in place to monitor and evaluate risk, and the plaintiffs did not attempt to show how these procedures were inadequate or had been consciously ignored by the defendants.[18] Furthermore, the plaintiff had rested its theory, for the most part, on "red flags," which should have alerted the directors of pending Citigroup losses. But the court rejected this argument, finding that the "red flags" were merely signs of the deteriorating economic condition, rather than evidence that would support a finding of liability. In other words, the red flags failed to demonstrate that the directors had been aware of wrongdoing at Citigroup or that they were consciously disregarding their duties to Citigroup.[19]

The Southern District of New York also declined to impose *Caremark* liability for a failure to monitor business risks in *In re Citigroup Shareholder Derivative Litigation*.[20] There, the *Caremark* claims alleged against Citigroup directors were similar to those raised in the Delaware action.[21] The Southern District relied on the reasoning of the Delaware case in rejecting the plaintiff shareholder's claim that the Citigroup directors had acted in bad faith by failing to act as the economic downturn approached.[22]

Notably, neither court ruled out the possibility that under some set of facts directors could possibly be held liable for their failure to monitor a company's business risk.[23] Thus companies should expect that this claim will continue to be alleged, especially by plaintiffs seeking damages stemming from the economic downturn.[24] But plaintiffs will face significant hurdles and defenses to such a claim. As the Delaware Chancery Court has reasoned: "To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting the Court to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions."[25]

Conduct Breaching the Duty to Monitor

In contrast to the *Citigroup* decisions, the plaintiffs in derivative litigation against officers and directors of AIG were permitted by the Delaware Chancery Court to proceed beyond the pleading stage. Rather than basing claims on the failure to monitor business risk, the plaintiffs in AIG asserted a more classic theory—that the directors failed to adequately monitor compliance with governing law, rules, and regulations.[26] Generally, cases permitting plaintiffs to proceed on *Caremark* claims fall into two categories: (1) egregious behavior by directors evidencing their knowledge of inadequate internal controls and (2) failure to develop and implement compliance systems.

Egregious Behavior

Directors who engage in significant wrongdoing, such that their activity resembles a "criminal operation," will be liable under a *Caremark* theory of failure to monitor because their involvement in the wrongdoing demonstrates that they knew the company's internal controls were inadequate and could be easily bypassed.[27]

In *AIG* the purported scheme alleged in the complaint included: misstating the company's financial performance to deceive investors; engaging in various "schemes" to avoid taxes; and conspiring with others to rig markets and competitive auctions.[28] The defendants argued, however, that the complaint was not properly pled in that the alleged facts did not show their involvement in the schemes. The court disagreed, finding that the complaint set out sufficient facts to survive a motion to dismiss and to demonstrate that the defendants would have been involved in, monitored, or supervised the transactions at issue because of their positions within the company and their financial experience.[29]

The court found that the "[c]omplaint fairly supports the assertion that AIG's Inner Circle led a…criminal organization."[30] The court acknowledged that "[a] cosmic wrong may have been done to the Inner Circle Defendants, whose members were victimized by a large number of lower level employees who, despite good faith efforts at oversight and the use of internal controls by the Inner Circle Defendants, were able to avoid detection and engage in widespread financial fraud."[31] However, at the motion to dismiss stage of the proceedings, "the pleading of direct involvement by…the Inner Circle Defendants in many of the specific alleged wrongs gives rise to a fair inference that the defendants knew that AIG's internal controls and compliance efforts were inadequate."[32] Therefore the court declined defendants' motion to dismiss the complaint, finding that plaintiffs had made out a breach of loyalty claim against the defendants for "knowingly tolerating inadequate internal controls and knowingly failing to monitor their subordinates' compliance with legal duties."[33]

No Controls

A complete lack of an internal control or monitoring system is a basis for imposing liability—even in the absence of any allegation that the director or officer in question participated in, approved of, or profited from the wrongdoing.[34] In this context, a director's lack of knowledge of the wrongdoing is not an excuse but, in essence, a confession of the failure to comply with oversight duties.[35]

Other Delaware cases have set out examples of the type of conduct that could serve as a predicate for a *Caremark* claim:

- lack of an audit committee or other important supervisory structures;
- the failure of the company's audit committee to meet;
- the existence of an audit committee that rarely met and devoted patently inadequate time to its work;
- the failure of the board or audit committee to investigate notice of serious improprieties or misconduct; or
- the board or audit committee learned of irregularities and encouraged their continuation.[36]

Conclusion

Despite the *Citigroup* rulings, there is ample reason for corporations to have robust and up-to-date compliance programs. Such programs are mandated by federal laws and regulations, as well as by a variety of private entities, such as the New York Stock Exchange and NASDAQ.[37] A strong compliance program will contribute to the defenses of *Caremark* claims leveled against directors and officers. Finally, if regulators or prosecutors take action as a result of wrongdoing, the existence of a well-functioning compliance program may reduce fines and sanctions.[38]

> *"If regulators or prosecutors take action as a result of wrongdoing, the existence of a well-functioning compliance program may reduce fines and sanctions."*

Endnotes

1. *Grimes v. Donald*, 673 A.2d 1207, 1214-15 (Del. 1996), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).
2. The law of the state of incorporation typically governs the duties, responsibilities, and obligations of directors of corporations. *See, e.g., Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 98–99, 101 (1991).
3. Federal law is increasingly encroaching on corporate governance duties and obligations. Sarbanes-Oxley Act of 2002, § 404, 15 U.S.C. § 7262(a) (directing the SEC to prescribe rules requiring companies to "establish[] and maintain[] an adequate internal control structure and procedures for financial reporting"); United States Attorneys' Manual, Principles of Federal Prosecution of Business, §§ 9-28.300, 9-28.800, http://www.usdoj.gov/usao/eousa/foia_re ading_room/sam/title9/28mcrm.htm ("In evaluating compliance programs [in connection with an investigation or a determination of whether to pursue or accept a plea from a corporation], prosecutors may consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct.").
4. *See, e.g.*, NYSE Listed Company Manual § 303A.07(c)(i)(A) (requiring audit committee charters to address committee's involvement with the listed company's financial statements and the listed company's compliance with legal and regulatory requirements); NASDAQ Listing R. 5610 ("Each Company shall adopt a code of conduct applicable to all directors, officers and employees…."); FINRA Rules R. 3130(b) ("Each member shall have its chief executive officer…certify annually…that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations.…").
5. 698 A.2d 959, 970 (Del. Ch. 1996).
6. *Id.*
7. *Id.* at 971. The duty to monitor is also included within the oversight responsibilities listed by the Model Business Corporation Act for boards of public companies. Model Bus. Corp. Act § 8.01(c). Those responsibilities include the supervision of "policies and practices to foster the corporation's compliance with law and ethical conduct," "the effectiveness of the corporation's internal controls," and "arrangements for providing adequate and timely information to directors." *Id.*
8. *Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006).
9. *Id.*
10. *Id.* at 370.
11. *Gantler v. Stephens*, 965 A.2d 695, 708–09 (Del. 2009).
12. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009); *In re Citigroup Inc. S'holder Derivative Litig.*, No. 07 CIV. 9841, 2009 WL 2610746 (S.D.N.Y. Aug. 25, 2009).

13. 964 A.2d 106 (Del. Ch. 2009).

14. *Id.* at 131.

15. *Id.*

16. *Id.* n.78.

17. *Id.* at 123, 126.

18. *Id.* at 127–28.

19. *Id.* at 128.

20. No. 07 CIV. 9841, 2009 WL 2610746 (S.D.N.Y. Aug. 25, 2009).

21. *Id.*

22. *Id.* at *6-7. Directors will also not be liable under *Caremark* for failing to monitor the personal affairs of a senior executive, even where the executive is as closely associated with the company as Martha Stewart was with Martha Stewart Living Omnimedia, Inc. *Beam v. Stewart*, 833 A.2d 961, 971–72 (Del. Ch. 2003). In *Beam*, a derivative action was filed against various directors of Martha Stewart Living Omnimedia, Inc. based, in part, on their failure to monitor Martha Stewart's personal, financial, and legal affairs. *Id.* at 970-71. These allegations stemmed from Martha Stewart's alleged trading of stock of ImClome Systems, Inc. on inside information. The court easily dismissed plaintiff's claim as a "patently unreasonable" extension of the board's oversight responsibilities. *Id.* at 971–72.

23. *See, e.g.*, *In re Citigroup*, 964 A.2d at 125, 126.

24. *See, e.g.*, *La. Mun. Police Employees Ret. Sys. v. Blankfein*, No. 08 Civ. 7605(LBS), 2009 WL 1422868 (May 19, 2009 S.D.N.Y.).

25. *In re Citigroup*, 964 A.2d at 126.

26. *Am. Int'l Group v. Greenberg*, 965 A.2d 763 (Del. Ch. 2009).

27. *Id.*

28. *Id.* at 775.

29. *Id.* at 797–99.

30. *Id.* at 799.

31. *Id.* at 777.

32. *Id.* at 777.

33. *Id.* at 799. The court in the AIG case analyzed the complaint under the traditional and plaintiff-friendly pleading standard of rule 12(b)(6), rather than the more difficult particularized pleading standard of rule 23.1 because of the unique procedural posture of the case. *Am. Int'l Group*, 965 A.2d at 778. The AIG board had created a special litigation committee to determine what action the corporation should take with respect to the derivative complaint, and vested full authority in the special committee, including whether to pursue the claims set out in the derivative complaint or whether to have them dismissed. Following its investigation the special committee decided to "remain neutral" with respect to the relevant defendants. Therefore, any demand on the board would have been futile and was excused. As such, defendants' motion to dismiss was evaluated under rule 12(b)(6). *Compare* Del. Ct. Ch. R. 12(b)(6), *with id.* R. 23.1(a).

34. *ATR-KIM ENG Financial Corp. v. Araneta*, No. CIV.A. 489-N, 2006 WL 3783520 (Del. Ch. Dec. 21, 2006).

35. *Id.*

36. *David Shaev Profit Sharing Account v. Armstrong*, No. 1449-N, 2006 WL 391931, *5 (Del. Ch. Feb. 13, 2006), *aff'd*, 911 A.2d 802 (Del.); *Guttman v. Huang*, 823 A.2d 492, 506–07 (Del. Ch. 2003).

37. *See supra* notes 4–5.

38. *See supra* note 4.

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Corporate Governance and Merger Control: How Control Rights Affect Merger Control Requirements

By Olivier N. Antoine, Michael Koebele and Hazel Yin

More than 70 countries have now enacted merger control statutes, and the number continues to grow. Antitrust agencies worldwide now have jurisdiction to review, potentially delay, and block proposed transactions raising antitrust issues in their jurisdiction. One of the most recent entrant on the scene, the Anti Monopoly Bureau of the Ministry of Commerce (Mofcom) of the People's Republic of China, blocked one high-profile transaction and significantly altered several cross-border transactions since becoming effective in August 2008.[1]

The result of this proliferation is that mergers between multinational corporations frequently trigger merger control requirements in multiple jurisdictions. Yet, merger control regimes vary significantly on a range of important procedural issues. For example, while most merger control regimes require the parties to suspend closing of the transaction before receiving clearance (or under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR), the expiration of the HSR waiting period), some regimes, such as Brazil, allow the parties to close pending review. Similarly, while most countries impose a mandatory obligation on the parties to file transactions with their antitrust agencies, others, such as the U.K., make this a voluntary option.

Merger control regimes also vary significantly as to which transactions fall within their jurisdiction. The question of whether a transaction requires approval needs to be answered following the rules of each jurisdiction. By and large, this is a two-step analysis, where both steps must be met. The first step focuses on whether the transaction exceeds the jurisdictional thresholds. These thresholds are typically based on the revenues derived by the merging parties in each country of operation, their assets in these countries, or the market share held by the parties. Under the European Merger Control Regulation (EMCR), for example, the revenue thresholds are as follows: (1) the parties to a transaction (meaning the acquirer, or acquirers, and the target) must achieve combined revenues of more than € 5 billion worldwide, and (2) each of at least two parties to the transaction must have derived in excess of € 250 million in EU-wide revenues.[2] But that is just the first step of the analysis. Even if these revenue thresholds are exceeded, a filing is not required if the second step is not met.

The second step of the analysis—present in most merger control regimes (with the notable partial exception of the U.S.)—is a corporate governance question: whether the acquirer, or acquirers, will "acquire control" over the target? The definition of control, however, varies greatly, so much so that it is possible for companies to change hands entirely without it being an "acquisition of control" for merger control purposes under the ECMR and most merger control laws modeled on the ECMR. And no control means no filing obligation and no antitrust agency in the critical path to closing. Therefore, as companies and corporate lawyers structure term sheets, shareholder agreements and other operating agreements, it is important to fully grasp the impact of their corporate governance choice on the merger control process. This is even more important when drafters of these corporate agreements are used to the U.S. analysis under the HSR Act, which does not require a change of control.[3]

> *"[A]s companies and corporate lawyers structure term sheets, shareholder agreements and other operating agreements, it is important to fully grasp the impact of their corporate governance choice on the merger control process."*

The ECMR Definition of Control

A filing at the European Commission is only required if there is a proposed change of control. One or more buyers must propose to acquire control over the target.[4] The definition of control is relatively simple, but has counterintuitive consequences. Control means either one of three things:

1. Acquisition of more than 50% of the voting stock;[5] or
2. "Acquisition" of more than 50% of the board seat representation; or
3. Veto power over "strategic commercial decision."

This is an alternative and not cumulative test. The definition of "strategic commercial decisions" becomes critically important in consortium deals in which no party acquires more than 50% of the voting stock, or more than 50% of board representation. In such circumstances, which are common in consortium deals, the question of whether one or more acquirer has veto over "strategic commercial decisions" will determine whether a filing is required.

The European Commission's Consolidated Jurisdictional Notice defines which rights confer control. First, these rights "must go beyond the veto rights normally accorded to minority shareholders in order to protect their financial interest in the joint venture."[6] Second, these rights cover issues such as "the budget, the business plan, major investments or the appointment of senior management."[7] The Notice adds that "in order to acquire joint control, it is not necessary for a minority shareholder to have all the veto rights mentioned above. It may be sufficient that only some, or even such right, exists. Whether or not this is the case depends upon the precise content of the veto right itself and also the importance of this right in the context of the specific business of the joint venture."[8] So there is some flexibility for the Commission to determine, on a case-by-case basis, which of these rights confer control.

> *"One of the keystones of the ECMR is one-stop shopping: if the European Commission has jurisdiction, the national competition agencies no longer have jurisdiction."*

Switching Majorities

But there is so much flexibility when the parties structure the transaction to exclude any such right. If no party proposes to acquire either (1) 50% of voting rights,[9] (2) 50% of board seats, or (3) veto right over strategic commercial decision, this is not an acquisition of control. Rather, this is a situation of potential "switching majorities" or "changing coalitions"[10] over which the European Commission cannot assert jurisdiction, regardless of whether the transaction raises substantive antitrust concerns.

For example, the joint acquisition of ContentGuard by Microsoft, Time Warner and Thomson escaped EC jurisdiction even though the Commission had raised concerns about the initial structuring of this acquisition. In 2004, Microsoft and Time Warner notified the European Commission of their proposed acquisition of ContentGuard from Xerox. The initial structuring of this acquisition gave Microsoft and Time Warner 48% of the voting rights in ContentGuard.[11] In addition, they entered into a shareholder agreement which gave them joint control over ContentGuard.[12] At the time, ContentGuard was one of the main digital rights managements (DRM) patent holders.[13] After an initial review, the European Commission opened an in-depth "second phase" investigation to assess whether the acquisition would have given Microsoft the ability to use ContentGuard's DRM technology in an anticompetitive manner.[14] Following this development, Microsoft and Time Warner altered their shareholder agreement and invited Thomson to join them in acquiring ContentGuard. This resulted in an acquisition of one-third of the equity by each party, with no significant veto rights. As a consequence, the European Commission no longer had jurisdiction over this transaction under the ECMR.

Germany and Austria

One of the keystones of the ECMR is one-stop shopping: if the European Commission has jurisdiction, the national competition agencies no longer have jurisdiction. And vice versa, if the Commission does not have jurisdiction, the parties need to assess whether their transaction requires notification with national competition agencies. This plays a role in consortium transactions, as a few EU Member States do not follow the ECMR's approach regarding switching majorities. The two most important exceptions are Germany and Austria. There, an acquisition of 25% of the stock of a company may require a filing.[15] In addition to this clear-cut rule, German law provides that a filing may be required upon "the exercise of competitively significant influence."[16]

The German Merger Control Agency (the Bundeskartellamt) has recently used this provision to block the acquisition of a 13.75% equity interest in a competitor.[17] In its decision, the Bundeskartellamt explained that it is sufficient for a finding of "competitively significant influence" that the target company and the acquirer be "intertwined in a way that severely limits competition and prevents them from acting as independent enterprises in the future."[18] Key facts in the Bundeskartellamt's analysis were: (i) the low attendance rate at shareholders' meetings of between 35–37% in the three years preceding the proposed transaction, (ii) the fact that there was no majority shareholder, (iii) the fact that the second largest shareholder held only 5% of the shares, and (iv) that the acquirer planned to obtain three (out of 12) seats in the Board of Directors.[19] The Bundeskartellamt also emphasized that according to the acquirer's own statements, the investment in the competing target company was "strategic" and not merely of a financial nature.[20]

China

Like the ECMR, the Chinese Anti-Monopoly Law provides for a mandatory pre-closing merger control regime. But the question of what constitutes an acquisition of control remains open. In January 2009, Mofcom issued a draft "Interim Regulation on Filing of Business Concentration." The definition of what constitutes "control" in this draft Interim Regulation potentially gives Mofcom the ability to review most minority acquisitions. Acquiring "control" means either (1) acquiring "more than 50% of voting shares or assets of other operators"; or (2) having the ability to (i) appoint at least one director or one "senior management personnel of other operators," (ii) veto the financial budget, (iii) run the operations, (iv) determine pricing, (v) veto material investment or (vi) veto any other major management or operations decision. To the extent this provision remains in the final Regulation, this would constitute a significant difference between the Chinese and European approach to merger control.

Conclusion

The European and Chinese merger control rules show that understanding the intricacies of merger control regulations may be of use in the early stages of the drafting of operating agreements. In a time when time and financing constraints continue to pressure the merger and acquisition market, and as merger and acquisitions continue to cross borders, antitrust counsel versed in global merger control rules can provide early insight to the optimal corporate structure to get a deal through the merger control process as quickly as feasible.

Endnotes

1. Mofcom blocked Coca-Cola Co.'s proposed $2.4 billion acquisition of Huiyuan Co. and imposed conditions on several transactions including InBev's $52 billion acquisition of Anheuser-Busch, Mitsubishi Rayon's $1.6 billion acquisition of Lucite International, and Pfizer's $68 billion acquisition of Wyeth.
2. *See* Art. 2(1) ECMR *available at* http://ec.europa.eu/competition/mergers/legislation/legislation.html. The ECMR also provides for an alternate, smaller test: (1) Combined revenues of more than € 2.5 billion worldwide; (2) combined revenues of all the parties in each of at least three EU Member States above € 100 million; (3) combined revenues of each of at least two parties to the transaction in these three EU Member States must exceed € 25 million, and (4) and the EU-wide revenue of each of at least two parties to the transaction must exceed € 100 million.
3. Under the HSR Act, an acquisition that results in the acquiring person holding more than $65.2 million of the voting securities of another company may require a filing, even if the amount acquired represents a small percentage of the voting stock of the target.
4. *See* Art. Art. 3(1)(b) EMCR Art. 3(1)(a) further provides for merger review for transactions where two or more previously independent entities merge into one single entity.
5. Even the acquisition of less than 50% of the voting stock can result in the acquisition of control (and thus, the obligation to file), if such shareholding is likely to achieve a majority at the shareholders' meeting due to widely dispersed shares and limited shareholder attendance at shareholders' meetings, *see* European Commission, Consolidated Jurisdictional Notice under Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings [2008] C95/1, Para. 59. Recently, the European Commission imposed a fine of € 20 million on the electricity producer and retailer Electrabel for closing a transaction without prior approval because the European Commission took the position that Electrabel had acquired a minority shareholding that gave rise to control, and the transaction was thus notifiable to the European Commission; *see* Commission Press Release of 6 June 2009, IP/09/895.
6. Commission Consolidated Jurisdictional Notice, Para. 66.
7. Commission Consolidated Jurisdictional Notice, Para. 67.
8. *Id.*
9. *See* note 5 above.
10. *See* Commission Consolidated Jurisdictional Notice, Para. 80: "In the absence of strong common interests […] the possibility of changing coalitions between minority shareholders will normally exclude the assumption of joint control. Where there is no stable majority in the decision-making procedure and the majority can on each occasion be any of the various combinations possible amongst the minority shareholders, it cannot be assumed that the minority shareholders (or a certain group thereof) will jointly control the undertaking. In this context, it is not sufficient that there are agreements between two or more parties having an equal shareholding in the capital of an undertaking which establish identical rights and powers between the parties, where these fall short of strategic veto rights. For example, in the case of an undertaking where three shareholders each own one-third of the share capital and each elect one-third of the members of the Board of Directors, the shareholders do not have joint control since decisions are required to be taken on the basis of a simple majority."
11. *See* Commission Press Release of 15 March 2005, IP/05/295.
12. *Id.*
13. *See* Commission Press Release of 25 August 2004, IP/04/1044.
14. *Id.*
15. Section 7(1)(No.3) of Austrian Cartel Act of 2005 and Section 37(1)(No.3a) of the German Act Against Restraints of Competition.
16. Section 37(1)(No.4) of the German Act Against Restraints of Competition.
17. Federal Cartel Office, Decision of 27 February 2008, B5-198/07—*A-TEC Industries AG / Norddeutsche Affinerie AG.*
18. *Id.* at 24.
19. *Id.* at 17–24.
20. *Id.* at 20. Critical of the Bundeskartellamt's decision, *see* Andreas Weitbreach/Georg Weidenbach, *Wettbewerblich erheblicher Einfluss auf börsennotierte Aktiengesellschaften*, 58 W.u.W. 788 (2008).

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"Say on Pay": Does It Really Give Shareholders What They Want?

By Nanette C. Heide

Public companies have evolved to meet the challenges of providing access to capital that is necessary to operate large businesses. Inherent in this development has been the separation of the operation of the business (management) from the owners of the business (shareholders). This separation has created the potential for the management of the business to act in ways that might not necessarily benefit the owners of the business, i.e., managers might have incentives that will secure higher remuneration at the expense of what may be in the best interests of the shareholders.

> *"'Say on Pay' has had extensive international adoption and has been voluntarily adopted by a handful of U.S. companies."*

Attempts to overcome this problem have led to various mechanisms to align interests, which include electing directors on the board of directors to oversee management, including the board's appointment of the Chief Executive Officer (CEO), and the shareholders' ability to replace such directors. In addition, regulatory schemes have evolved to further attempt to align the interests of the owners and management of a public company. In theory, these divergences of interests can be ameliorated by the realignment of management compensation packages with the interests of the shareholders.[1]

Recently, the Obama administration sent Congress a proposal that would give corporate shareholders an annual non-binding vote on executive pay and require more independence for boardroom compensation committees.[2] This "Say on Pay" legislation is designed to encourage greater accountability and better disclosure in setting compensation. The Corporate and Financial Institution Fairness Act of 2009 was passed by the House of Representatives on July 31, 2009, and requires all public companies to do the following:

- Give shareholders a nonbinding say on pay vote on executive compensation and golden parachute packages;
- Disclose compensation paid to executive officers in connection with a merger or other business combination, whenever shareholders are asked to approve such a transaction;
- Maintain an independent Compensation Committee;[3] and
- Disclose the independence of any compensation consultant or other advisor to the compensation committee.

The legislation also requires that financial institutions with assets of $1 billion or more disclose to federal regulators the details of all incentive-based compensation arrangements offered by the institution. This portion of the legislation would be applicable not only to banks and bank holding companies, but also to broker-dealers, investment advisors and other financial institutions that the federal regulators determine should be covered.

The Securities and Exchange Commission (SEC) has proposed rules that would require, in certain circumstances, expanded disclosure regarding compensation for not only executive officers, but all employees.[4] The detailed disclosure focuses on high-risk business units, most profitable business units, business units that provide a significant percentage of revenues, and compensation programs that are significantly different from overall company approaches. There is an additional proposal that concerns valuing equity awards in disclosure tables. The SEC proposes a fair value on date of grant rather than an annual valuation.

This article discusses whether the "Say on Pay" mandate adequately addresses the pressure points between compensation for management in order to best serve the interests of the shareholders. It also provides some practical pointers to counsel for managing in the "Say on Pay" environment.

"Say on Pay": History Learned

The U.S. legislation closely follows the provision of the American Recovery and Reinvestment Act that requires all participants in the Treasury Department's Troubled Asset Relief Program (TARP) to give shareholders a say on pay by a nonbinding annual vote. "Say on Pay" has had extensive international adoption and has been voluntarily adopted by a handful of U.S. companies.

In Microsoft's Proxy Statement filed for its annual shareholders' meeting held on November 19, 2009, Microsoft proposed a nonbinding, advisory vote every three years on the compensation programs for its senior executive officers. Microsoft proposed the three-year cycle based on the following considerations: (1) its compensation program is designed to induce and reward performance over a multi-year cycle, (2) a three-year cycle provides investors with sufficient time to evaluate the effectiveness of its short and long-term compensation strategies, and (3) many shareholders rely on proxy advisory firms, which evaluate compensation programs of a large number of public companies and this longer cycle will enable advisory firms to provide a more detailed analysis and thorough recommendation.[5] Microsoft said that it based its proposal on discussions with shareholders, governance advocates and other companies.

The "Say on Pay" policy was adopted by the United Kingdom in 2002. Similar policies have been instituted in Australia, Sweden, Norway and the Netherlands. In the U.K., the "Say on Pay" policy has led to substantially increased dialog between firms and shareholders on compensation.[6] This dialog has been accompanied by activity by both boards and shareholder groups to improve compensation packages, including compensation committees (pay panels) meeting more frequently and hiring independent outside advice. The U.K.'s shareholder groups have developed detailed compensation guidelines that improve practices and systematize the consultation process.[7] Supporters argue that the U.K. experience has not given rise to many of the fears raised by critics of "Say on Pay"—negative votes have been rare, although GlaxoSmithKline did receive a negative vote. In the U.K., these guidelines have enabled the achievement of a "yes" vote to become a straightforward matter of adhering to the guidelines issued by the investor groups.

In Australia, however, the Greens and union groups recently criticized the Productivity Committee's report[8] on executive compensation as being "bereft of any real action."[9] The criticism included that the report failed to recommend a pay cap, failed to empower shareholders to reject excessive CEO packages and failed to tie CEO payments to any performance criteria at all. One of the key recommendations is to give shareholders a greater say by requiring boards to stand down if their remuneration reports were voted down twice at annual shareholder meetings. Another proposal from a senator included that all golden handshakes (parachutes) over $1 million would have to be approved by the shareholders.

Instituting "Say on Pay" in the U.S.

Proponents urge that the "Say on Pay" proposal provide shareholders with a simple method to vote their concern over a company's compensation practices. The "Say on Pay" requirement, and the corresponding requirements for an independent compensation committee, will encourage, and perhaps mandate, the Compensation Committee to scrutinize the pay packages it is reviewing to ensure that they are in the best interests of the shareholders.

But how much guidance and insight can a company and its board gain from a simple "yes / no" referendum on the company's compensation proposal? If there is a "no" vote, is there feedback available so that the board can implement the changes required to obtain a "yes" vote? At large, publicly traded companies, well designed compensation packages are complex and have many facets, and require tremendous amounts of time and energy for preparation annually. A simple "yes / no" referendum may encourage shareholders solely to look at the bottom line and overlook the essential considerations of pay structure, marketplace equality and the pay-for-performance relationship that comprises these compensation packages.

While implementation in the U.K. appears to have gone smoothly, especially given the guidelines developed by its large shareholder groups, stock ownership in the U.S. is far less consolidated than in the U.K. As a result, most institutional shareholders may rely heavily on the guidance issued by proxy advisory firms in making their "Say on Pay" decision.[10] As a result, RiskMetrics Group, which acquired Institutional Shareholders Services (ISS) in 2007, may now play a significant role in the "Say on Pay" decision.

Moreover, proposals from the SEC require that the Compensation Discussion and Analysis (CDA) cover employee compensation programs that create incentives which materially affect company risk, disclosure regarding the philosophy of compensating high-risk employees and risk assessment, if any, applied to designing the program, as well as claw-backs and equity holding periods and how compensation policies are adjusted to address changes in company risk.[11] While increased regulation is understandable given the current status of our economic markets, it is questionable as to whether increased regulation will improve director performance or increase director liability. In effect, the liability for assessment of compensation, as it relates to financial risk, seems to have been shifted to the compensation committee for all employees, not just senior executives.

Practical Considerations

The advent of "Say on Pay" for a company means, as a practical matter, that its executive pay policies and procedures will have to meet the guidelines of ISS. If the company fails to meet the guidelines, it has a strong risk of ISS recommending that shareholders vote "No on Pay." Failure to remedy the compensation policy could lead to a no vote for the compensation committee and perhaps the entire board.

In its report, *Evaluating U.S. Company Management Say on Pay Proposals* (March 2009), RiskMetrics Group provided that shareholders should consider the following when evaluating each company's compensation program in order to determine their votes:

- While the SEC has issued little guidance for say on pay proposals, to date only a few companies have taken unique approaches to the proposal language; companies may continue to have some flexibility in that regard, however. An evaluation should begin with determining what the proposal is asking for. The wider the scope of the proposal's resolve clause, the wider the scope of the compensation analysis needed to conclude a vote for or against the proposal.
- Consider specific areas of evaluation, chiefly: executives' pay relative to company performance; the relationship of incentive performance metrics and goals to the company's stated business strategy; the appropriateness of "non-performance related" pay elements and the company's pay benchmarking practices; clarity of disclosures; and the company's responsiveness to shareholder input on executive pay issues.
- In light of questions about incentives that may have contributed to "excessive" risk-taking at financial services companies, investors are also beginning to appreciate techniques that may mitigate risk-taking and strengthen long-term alignment between executives' and shareholders' interests, such as stringent "claw-back" policies, substantial holding requirements and / or bonus "banks" that tie ultimate payouts to sustained positive performance.
- Ultimately, each vote determination may involve a holistic evaluation of the company's pay system and its relationship to actual and potential long-term shareholder value. That said, high opposition votes for management say on pay proposals in the U.S. market are most likely to be seen at "outlier" companies that demonstrate poor board stewardship of shareholder interests with respect to executive compensation programs.

All of these are determining factors in whether shareholders will vote in favor of management's "Say on Pay" proposal.

In order to be prepared for the pending legislation, a board should immediately begin to determine what steps it will need to take in order to provide the appropriate disclosure regarding its compensation policies and its compensation committee. This should include:

- Evaluating its current Compensation Committee for independence as well as competency of its members. In addition, the Compensation Committee charter should be reviewed to determine if it needs to be revised in order to enable the committee to hire and retain outside independent professionals;
- Exploring or revising, if applicable, a risk assessment framework;
- Considering overall compensation philosophies and goals, including performance metrics, pay mix, retirement benefits, perquisites, and severance pay;
- Identifying companies within its peer group; and
- Speaking to the company's largest shareholders and ascertaining what they think.

Company counsel should begin gathering such information now and structuring substantive discussion so that they can be responsive to anticipated 2010 proxy disclosure requirements.

Endnotes

1. Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932).
2. The Treasury Department's proposal is publicly *available at* http: / / www.treasury.gov / press / releases / docs / tg_218IX.pdf.
3. This is required for public companies listed on a national securities exchange.
4. *See* SEC Release No. 33-9052 (July 10, 2009).
5. The Microsoft proxy is publicly *available at* http: / / www.sec.gov / Archives / edgar / data / 789019 / 000119312509194558 / ddefa14a.htm.
6. Fabrizio Ferri and David Maber, Say on Pay Votes and CEO Compensation: Evidence from the UK (March 2009); Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward: Say-On-Pay, http: / / www.treas.gov / press / release / tg219.htm.
7. *Id.*
8. The Executive Remuneration Discussion Draft published by the Productivity Commission is publicly *available at* http: / / www.pc.gov.au / projects / inquiry / executive-remuneration / draft.
9. Bob Brown—World News Australia (September 30, 2009), publicly *available at* http: / / www.sbs.com.au / news / print / Article / 1101767.
10. Deloitte, Exploring the New "Say on Pay" Requirements (April 2009).
11. SEC Release Nos. 33-9052, 34-61280, IC-28817; File No. S7-13-09, Proxy Disclosure and Solicitation Enhancements (July 10, 2009), publicly *available at* http: / / www.sec.gov / rules / proposed / 2009 / 33-9052.pdf.

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Nonprofit Governance: An Overview

By James A. Woehlke

This article is the first in a series on nonprofit governance and provides an overview of the area. Nonprofit organizations, as discussed herein, are not limited to those organizations with charitable purposes, but include both public-benefit entities (such as social benefit organizations, colleges and universities, and nonprofit hospitals) and member-benefit entities (such as trade associations, social clubs, and unions).

Governance as a Process

In the nonprofit organization context, governance is the process that enables a board to accomplish the purpose of the nonprofit entity as identified in its governing documents and by key constituencies. Governance begins with the identification of the corporate purpose by the nonprofit's founders, including the articulation of that purpose to the IRS in the organization's application for tax exemption (Form 1023, the application for recognition of exemption by organizations described in Internal Revenue Code § 501(c)(3) or Form 1024, application for recognition of all other exempt organizations). It is important for the board to refer to these documents from time to time to avoid "mission creep," which entails permitting an organization to expand into new endeavors beyond its legal purpose. (If mission creep does occur, amendment of the certificate of incorporation or disclosure to the IRS, or both, may be required or the expansion to the mission may need to be abandoned.)

The governance process continues with development of a mission or vision, or both, for the organization. There often is overlap between vision and mission statements. Vision statements describe what the organization intends to accomplish in the future. The mission statement states in broad terms the activities the organization is undertaking to achieve its purpose. The vision is what the organization aspires to become; the mission is what it is all about in the present. Ideally, the vision and mission statements will serve as vehicles to brand the organization and will be useful as a focus for fundraising.

A good example of a New York nonprofit with both vision and mission statements is Phelps Memorial Hospital Center in Sleepy Hollow, whose vision statement is:

> In 10 years we will be:
>
> - A financially sound, physically modern and technologically advanced institution whose staff and employees enjoy their work;
> - Known throughout the region for excellent clinical services and nursing care, measured by satisfied patients and community;
> - Linked in creative and mutually beneficial ways with our medical staff to provide comprehensive primary health services and an appropriate spectrum of secondary and tertiary services;
> - Cooperating with other health care institutions to enhance our ability to provide high quality care at reasonable cost.

And its mission statement is:

> Phelps Memorial Hospital Center is dedicated to:
>
> - Improving the health of the community we serve;
> - Sustaining an environment of excellence where medical, social and rehabilitative services are delivered proficiently, efficiently and effectively;
> - Offering a broad range of preventive, diagnostic and treatment services;
> - Educating our community to achieve optimal health outcomes and quality of life;
> - Striving to enhance the personal and professional excellence of our medical, nursing, paraprofessional, technical, administrative and support staff;
> - Providing comprehensive care in a safe, modern environment where advanced medical techniques and effective management and planning are coupled with the strong Phelps tradition of caring.[1]

Frequently, as part of the process of developing a mission statement, organizations define their core values. Often, however, the legal purpose is not consulted in the process. Understandably, it can lead to mission creep if the board that is crafting the mission does so without reference to the historical legal purpose.

Moving Beyond the Mission

In carrying out their activities, board members need to remain cognizant of their fiduciary duties of care and loyalty. The duty of care includes preparation for and participation in board deliberations, staying informed about organization activities, delegating to qualified and responsible persons, and following up regularly. The duty of loyalty includes avoidance or disclosure of conflicts of interest and maintaining confidences. A third board duty, the duty of obedience, is often included in the duty of care. Regardless of its presentation, the duty of obedience requires that board members assure the organization operates within its legal purpose.

Armed with purpose and mission, the board needs to establish the organization's rules of the road. To what extent will it require separation of duties over financial matters? Will the chairperson[2] and treasurer be permitted to complete and sign checks without approval or review by others? Will two signatures be required for checks? Will the organization be permitted to obtain a credit account? Will contract signing authority be limited to the chairperson? What additional review will be required before contracts are signed? Who will have authority to hire staff? Will the board impose on itself any supermajorities in addition to those required by law or parliamentary practice? How many board members will be needed to conduct business (the quorum requirement)? What committees[3] should the organization use to carry out its mission? What authority should committees be granted and what limitations imposed on them? Will a given committee's composition be limited to board members, independent board members, other volunteers? Will there be an executive committee of the board and what limitations should be imposed on it? There is not one correct way to answer most of these questions and they ultimately need to be threshed out by the board through deliberation. What types of grants will the organization seek or provide to others? Who will approve those grants?

Establishing Rules of the Road

These rules of the road are contained in one or more of several sources: the organization's bylaws, board standing rules, policy statements, the organization's manuals and handbooks, its parliamentary authority. They evolve over time; an organization doesn't want to get ahead of what it needs in terms of governance rules or it gets bogged down in red tape. On the other hand, as an organization grows, the board needs to recognize that more – and more clearly defined—rules are necessary to provide guidance to board and staff.

Boards of smaller nonprofits are responsible for both governance and management of the entity. The activities of these organizations are carried out by the board members themselves and other volunteers. As the organization grows, however, to accomplish the organization's purposes, the board likely will need to hire paid staff to carry on day-to-day activities. Eventually, growth may necessitate the hiring of an executive director,[4] one of the most important decisions a board can make. From the point of hiring an executive director, the board is responsible for governance, which at that point includes oversight of the management of the organization, but not the management itself. Management has been delegated to the executive director.

Once an executive director has been hired, the board needs to recognize that, while the organization may have many employees, the board has only one, the executive director. Failure to observe this principle results in board meddling in the management of the organization and can lead to embarrassment for the organization and potentially for board members themselves, and occasionally even heightened risk of litigation.

Documents to Include In a Board Binder

1. Certificate / Articles of Incorporation;
2. Bylaws;
3. Board Standing Rules;
4. Form 1023 / 1024 Federal Tax Exemption Application;
5. Statements of Organization's Vision and Mission;
6. Strategic Plan;
7. Personal goals of the chairperson for the current year;
8. Three most recent reports to IRS (Form 990, "Return of Organization Exempt From Income Tax") and state authorities;
9. Three most recent audited annual financial statements and current year interim financials;
10. Text of board-approved policies with continuing effect;
11. Minutes for the current and immediately preceding year.

Constituencies Important to Governance

Four constituencies important to governance have already been mentioned: the founders, the board, volunteers, and paid staff. Depending on the organization, other important constituencies can include donors, members, regulators (the attorneys general in states of operation or solicitation, the IRS, other government officials charged with regulating the organization's program output or membership), service clients or customers. While governance is the responsibility of the board, which may not abdicate responsibility for those matters, input from many of these constituencies is often important for the board to effectively govern.

Leadership Development

The final governance function, one that often receives too little attention to the detriment of the organization, is leadership development. A board needs rotation of its membership to maintain freshness of perspective. It is important for a board to be periodically asked "Why" and "Why not" about very core governance issues. Over time, organizational practices help to define its culture, which ordinarily is a good result; but they can also ossify the organization and preclude it from moving into appropriate new territory. To achieve board rotation, board members need to realize that they will need at a minimum to take a hiatus from time to time. Also, there needs to be a mechanism to develop new leaders by encouraging their activity in the organization's programs and supporting committees.

Conclusion

This article provides an overview of nonprofit governance. Future articles will address the role of key board committees, the strategic plan as a policy document, and policies urged by the IRS in the new Form 990.

Endnotes

1. See http://www.phelpshospital.org/about_phelps/mission.php.
2. The chief volunteer officer of a nonprofit normally has the title president or chairperson of the board. This article will use the title chairperson to avoid confusion.
3. This article uses the term committee for volunteer groups assigned to carry out organizational business for the board. Nonprofit literature is using many additional terms including: advisory board, interest groups, task forces, working groups. The common thread is that before these groups become official, they need to be authorized by the board or through a process approved by the board.
4. Some organizations refer to the chief staff officer as president or CEO. This article will use the title Executive Director.

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Inside Books

A Little Light Reading

SUPREME COURTSHIP

Christopher Buckley
Twelve • 285 pages

Reviewed by Janice Handler

If you were good boys and girls and read ***The Nine*** as I suggested in the Fall '08 issue, you have done all your homework and are ready for a lighter view of the Nine—or some Nine as envisioned by Christopher Buckley, a deft comic novelist.

In ***Supreme Courtship***, the President of the U.S., Donald Vanderdamp (also known as Don Veto for disapproving every spending bill sent to him), annoyed at the Senate for rejecting two eminently qualified Supreme Court nominees, decides to get even by nominating America's most popular court TV Judge to the Supreme Court. After his previous nominee is nixed for insufficiently appreciating ***To Kill a Mockingbird***, the President chooses someone so beloved by voters that Congress won't have the guts to reject her—Pepper Cartwright, the star of the popular reality show Courtroom Six. The rest of this mostly unbelievable but nevertheless hilarious storyline involves how a feisty, gun-toting, iconoclastic cowgirl from Texas conquers the Court, finds love in the process, and, in her spare time, resolves a constitutional crisis relating to the presidency. All in a day's work, pardner!

Despite the levity and ridiculous story line, Christopher Buckley (former speechwriter to George H.W. Bush and son of the deceased editor of the *National Review*, William Buckley) knows plenty about the Court and plenty about politics. And he is an equal opportunity jabster who takes equal aim at pomposity, bureaucracy, and sophistry (none of which is in short supply in Washington).

On Supreme Court tenure, for example: "Supreme Court Associate Justice J. Mortimer Brinnin's deteriorating mental condition had been the subject of talk for some months now, but when he showed up for oral argument with his ears wrapped in aluminum foil, the consensus was that the time had finally come for him to retire."

On pork barrel projects: Don Veto vetoed federal spending for "a dam, a highway enhancement, a wind farm, a Museum of Gluten, an underground storage facility for fast food cooking grease, an Institute for the study of gravel, a postoperative transgender counseling center and an electric eel farm alternative energy source initiative."

On Presidential Campaigns: "Dexter's Agenda for America included (a) call for change, (b) a return to greatness, (c) a brighter future for all, not just some, Americans, (d) a pledge to change the way Washington does business."

Supreme Courtship may not be replete with serious themes, but who needs them when you can enjoy such delicious one-liners as: "If Intelligent Design exists, how would you explain the U.S. Tax Code?" and Question: "Why does everyone here think a Texas accent means you're illiterate?" Answer: "There are precedents."

Most comic novels don't specialize in complex characters, and this one is no exception. Senator Dexter Mitchell, the Chairman of the Senate Judiciary Committee (who might be Joe Biden), Justice Silvio Santamaria (who might be Antonin Scalia) and President Vanderdamp are fairly stock cartoons. But Pepper herself emerges as a surprisingly rounded and appealing character. You find yourself rooting for her whether she is struggling with an arcane bit of constitutional law or preventing the Chief Justice from hanging himself in the Supreme Court Conference room (his wife left him for a woman right after the Court legalized gay marriage).

If there is any theme at all in ***Supreme Courtship***, it is the permeability that exists today among government, politics, media, and entertainment. In one memorable chapter, Dexter Mitchell, now the star of the TV show *POTUS*, launches a real-life campaign for President. When his wife refuses to campaign, his TV wife steps in. "What's happening?" says President Vanderdamp at one point. "You can't tell anymore what's real and what isn't. Everything's all jumbled. The world has been reduced to a widescreen TV."

Of course, this plotline is too far out to confuse anyone. A totally unqualified woman being appointed to high office because of her gender and for political gain? Could never happen! Or could it? (Ask Sarah Palin.)

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