

Boardroom Briefing

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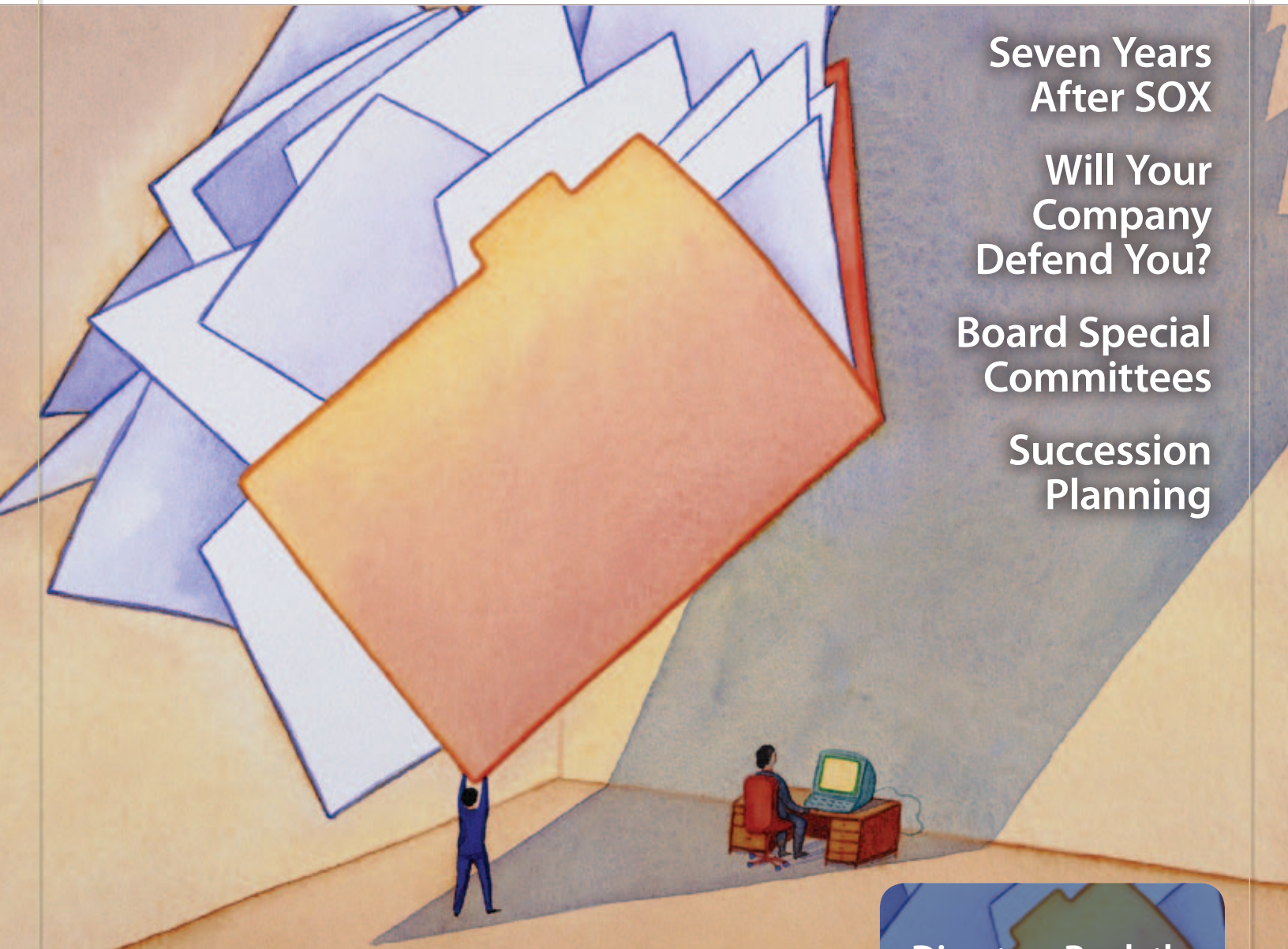
The Legal Issue 2009

Seven Years
After SOX

Will Your
Company
Defend You?

Board Special
Committees

Succession
Planning



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Directors Rank the
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The General Counsel as Mentor

By James Kristie

This is an underappreciated role, but one that can lead to a more effective board if such a relationship is forged between the general counsel and the directors.



James Kristie

many *Boardroom Briefing* readers would think of putting “mentor” on the list.

And yet that is precisely a vital role the general counsel should play in his or her relationship with directors.

I’m indebted to Raul Deju for identifying this overlooked role in an article he wrote for **Directors & Boards** titled “What a Board Needs from Its General Counsel” [Second Quarter 2005]. Deju, president of Deju Management Advisors Inc., has served in top positions—chairman, CEO, president, COO, as well as board member—of both public and private companies and not-for-profit enterprises. He has seen the general counsel in action in many different environments and relationships. His advice was well received then and is well worth reprising now in setting the tone for the informative advisories ahead in the pages of this Legal Issue 2009 *Boardroom Briefing*.

In the grand scheme of governance, corporate counsel must serve a board in several roles, Deju explained: “They need to be *teachers*, educating a board on its responsibilities under the law; *mentors*, advising the board on opportunities, liabilities, and approaches; *requestors*, requesting board actions as

When we think of the roles and duties of general counsel, particularly in relation to the board of directors, I’m guessing that not

appropriate; and *executors*, executing the board directives as assigned.”

Enlarging on the general counsel as mentor, Deju noted: “Because most board members are not lawyers, counsel is expected to continually assist directors in the discharge of their duties. This is particularly true in small public companies, where members may include founders, technical people, and early investors who have little experience participating in the management of a public company. ... Proper mentoring is an essential part of counsel’s responsibilities. General counsel should establish a relationship with each individual board member and meet their requirements for information. While this is somewhat time-consuming, it is the only way to ensure an effective board.

In the companies that he worked with, Deju stated that “the two most significant areas requiring mentoring involved the responsibilities of independent auditing and ensuring there are no conflict of interest relationships within the enterprise.”

To further illuminate the matter, Deju drafted a checklist of “The Top 20 Board Items in a General Counsel’s To-Do List.” Here are three items on that list that draw out the mentoring role of a GC:

- If moral/ethical paradigm shifts are needed for a board or executive management team to comply with Sarbanes-Oxley (SOX), counsel must make sure this shift happens quickly and completely. Compliance is not about just filling more paperwork; it is about “attitude.” It is about living and behaving

differently. In-house counsel must take a proactive role to educate the board about the importance of establishing and maintaining such a compliance mindset.

- Establish a bridge between directors and corporate executives that parallels the bridge between the CEO and the board, while recognizing the role of the CEO and never diminishing this role. When the CEO acts also as the chairperson of the board, make sure there are procedures in place to preserve the board’s independence and to ensure that conflicting opinions are presented to the board in a complete and open manner.
- Confirm that the board has an open and established process for selecting board members in a manner that ensures the preservation of the board’s ability to serve as owner representatives of the shareholders. Encourage diversity in the selection of board members.

This jury of one is convinced that a better understanding of how a general counsel can be a mentor to board members—and how the board can foster this mentoring relationship by the GC—will result in a stronger model of governance. I hope you are similarly persuaded.

In that spirit, let’s get underway with our third annual presentation of briefs to guide your decision making so that, shall we say, your deeds as directors don’t end up in a court record somewhere in the system of jurisprudence.

James Kristie is editor and associate publisher of **Directors & Boards**, and can be reached at jkristie@directorsandboards.com.

Opening Keynote 2010: A Governance Odyssey

By Robert M. Hart and Stephen Wallenstein

Hart and Wallenstein's annual update on the legal environment for directors



Robert M. Hart



Stephen Wallenstein

Since the enactment of SOX, an increasingly punitive and hostile environment toward public companies has developed, an environment which recently has been exacerbated by the most severe financial crisis since the Great Depression, a massive recession, high unemployment,

federal bailouts and large bonuses paid to employees of the recipient's of such bailouts. We'll see some of the results of this in new regulations for the 2010 proxy season.

Directors need to recognize that regardless of whether the failure of capitalism was attributable to deficient government policy and regulation or to greedy capitalists, stockholders have been hit hard by actions and inactions of boards of directors, managements, regulators and the government. Not surprisingly, regulatory focus has been aimed at the role and functioning of the boards of public companies. Unfortunately, reflecting policymakers' lack of understanding of how boards function and how state corporate laws work, many of the proposed regulations will only serve to further bureaucratize the board and its committees and

displace the historic private ordering corporate governance model with a government mandated model.

Where are we and where are we heading?

Since President Obama's inauguration we have seen an unprecedented volume of Federal regulatory and legislative actions and initiatives regarding such issues as executive compensation, risk management, "say on pay," shareholder nominations of directors, compensation committee independence, broker discretionary voting for directors and the separation of the CEO and Chairman roles. These and related matters threaten a Federal takeover of corporate governance.

Of particular note:

1. The House of Representatives passed the "Corporate Financial Institution Compensation Fairness Act of 2009," H.R. 3269, which would give shareholders a non-binding vote on executive compensation and golden parachutes, impose enhanced independence requirements on compensation committees, impose independence requirements on the compensation committee's consultants, and require Federal regulators to adopt rules for "covered financial institutions" restricting incentive-based compensation arrangements that "encourage inappropriate risks. . . ."
2. The SEC proposed rules that would require new disclosures in the proxy statement regarding the qualifications and experience of directors and executive officers, the company's overall

compensation program as it relates to the company's risk management, the role of the compensation committee's consultant in determining or recommending executive and director compensation, and the board's leadership structure and role in risk management, and which would provide shareholder access to a company's proxy statement to nominate directors and allow stockholder proposals to amend a company's governing documents regarding director nominating procedures.

3. Senator Schumer proposed the "Shareholders Bill of Rights Act of 2009," which would require a non-binding stockholder vote on executive compensation and golden parachutes, confirm the authority of the SEC to adopt rules providing shareholders access to a company's proxy statement to nominate directors, and require the SEC to adopt rules directing the national securities exchanges to prohibit the listing of companies that do not have an independent board chairperson, provide for the annual election of all directors, provide for majority voting for directors in uncontested elections and for the mandatory resignation of any director who does not receive a majority vote, and provide for a board risk committee comprised of independent directors.

What directors can expect in 2010

We believe that directors should recognize the inevitability of material changes in corporate governance and start now to consider how such changes can be best implemented to restore investor confidence and mitigate any adverse affects on the company's business.

The advisory vote on executive compensation provided for in H.R. 3269 will probably pass this year, but is not likely to apply to the 2010 proxy season. Nevertheless, compensation committees should be mindful of the expected 2011 requirements in shaping 2010 compensation.

Some form of SEC-imposed proxy access may be adopted but is unlikely to be applicable for the 2010 proxy season. The SEC will probably adopt rules allowing stockholder proposals to amend a company's by-laws to provide proxy access for director nominations which will be in effect for the 2010 proxy season. Together with 2009 amendments of the Delaware General Corporation Law enabling the adoption of such by-law provisions, the stockholder proposal route may be seen to be preferable to a government mandate of proxy access.

Enhanced SEC disclosure rules regarding the qualifications of directors to serve on the board and any committees on which they serve are likely to be adopted and in effect for the 2010 proxy season. The government's focus on individual director qualifications at Bank of America and AIG may presage regulation of individual director qualifications. Boards and directors should start thinking about how they want such individual information presented.

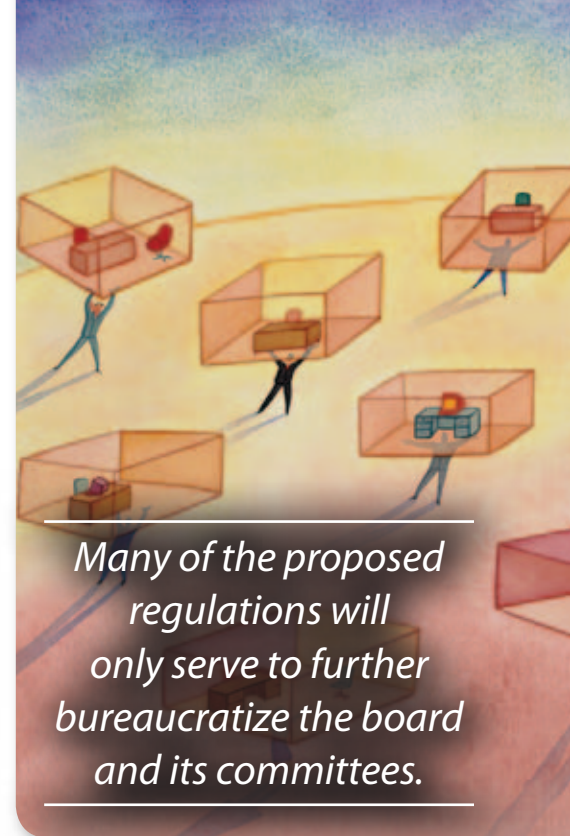
Enhanced SEC disclosure rules regarding risk management and executive compensation are likely to be adopted and in effect for the 2010 proxy season. Compensation committees should begin now to rethink how executive compensation matters are communicated to stockholders. The complexity of compensation disclosure regulations is rapidly bureaucratizing the compensation committee, much as SOX bureaucratized the audit committee, and compensation committees need to find ways to cut through the complexity and provide simple transparent information to investors.

Enhanced SEC disclosure rules regarding board leadership and the board's role in risk management are likely to be adopted and in effect for the 2010 proxy season. Risk management has, of course, always been an integral part of the board's primary focus on strategy and business performance. However, the regulatory treatment of risk management as a separate governance activity will lead to bureaucratization of risk management and may make some boards unduly risk averse. Ironically, the government is allowing failed financial institutions, like Citigroup, all of which had sophisticated risk management structures and committees, to continue their highly risky, but apparently profitable, trading operations leveraged with taxpayer capital.

Enforcement and Activism

Stung by criticism following the Madoff scandal, the SEC Enforcement Division will be more active and hard-nosed, using enforcement techniques more typical of the U.S. Attorneys' white collar crime practices. An early harbinger of its new approach was the announcement by SEC Enforcement Director Robert Khuzami of a broad reorganization of the Enforcement Division, including the creation of five specialized enforcement units, increased staffing, deployment of senior supervisory personnel to investigations, and increased delegation of subpoena power by the SEC to the staff of the Enforcement Division.

There will be continued pressure from activist investors to manage the company for short-term stock price performance. On the positive side, the SEC has adopted rules to curb naked short sales and has investigated instances of rumor mongering and other manipulative behavior, which had highlighted the susceptibility of public companies to opportunistic stock price manipulation. Moreover, the SEC has indicated that it will revisit the definition of beneficial ownership, which may curb the use by



Many of the proposed regulations will only serve to further bureaucratize the board and its committees.

activist investors of derivatives to amass greater voting power than their economic investment or to accumulate a large economic stake without triggering 13D disclosure requirements.

Unfortunately, thoughtful proposals from investor and business leaders promoting long-term value creation, such as the set of principles for long-term valuation creation released in 2007 by the Aspen Institute, appear to have been pushed aside in the current environment. At the same time, the erosion of board-centric structures, such as poison pills, classified boards and plurality voting, have left boards particularly vulnerable to the demands of activist investors. Absent a large base of long-term stockholders, which few companies seem to have these days, boards will need to find ways to cope with activists.

Another major challenge for directors in this environment is to maintain an efficient, effective and collegial board. Narrowing definitions of director independence and mandates that the audit, compensation and nominating committees consist only of independent directors tend to disenfranchise directors

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Will Your Company Defend You?

By Robert F. Quaintance, Jr. and Colby A. Smith

Proving your innocence in a securities class action may be a luxury you can no longer afford.



Robert F. Quaintance, Jr.



Colby A. Smith

The well-established principle that indemnified directors and officers who are sued are entitled to have their companies advance their defense costs, without any prior showing of lack of culpability, is under attack. Ironically, the attackers' chosen weapon is a provision of the Private Litigation Securities Reform

Act (PSLRA), a law whose principal purpose was to protect public companies and their directors and officers from unfounded and potentially extortionate lawsuits. Under the laws of Delaware and other states, a corporation's charter, bylaws or indemnification agreements may require it to advance a corporate official's defense costs, subject only to the official's promise to repay the advance if he or she ultimately is found not to have been entitled to indemnification. The right to have defense costs advanced is an important inducement to qualified persons to serve as directors and officers of public companies.

In the recent securities class action involving HealthSouth Corporation and its founder and former CEO, Richard Scrushy, HealthSouth settled, Scrushy did not (he was not even invited to participate in the settlement talks), and a federal court of appeals approved, over Scrushy's objection, a "bar order"

that prevented Scrushy from enforcing HealthSouth's contractual obligation to advance his continuing defense costs.

The PSLRA calls for bar orders in order to encourage settlements. The orders typically prohibit plaintiffs from seeking additional money from settling defendants and extinguish rights of contribution among settling and non-settling defendants (thus preventing a non-settling defendant from claiming later that the settling defendant did not pay its fair share of the loss). The HealthSouth court, in a novel ruling, held that a bar order could prohibit advancement of defense costs to non-settling corporate officials.

In reaching this unprecedented result, the court said that the public policies in favor of settlement and against indemnification for securities law violations outweigh the public policy in favor of advancement (and, apparently, although the court did not say it this way, the public policy in favor of enforcing customary corporate obligations valid under the law of the corporation's state of organization). The court did not cite any actual wrongdoing by Scrushy in support of its decision, but seemed moved by the plaintiffs' allegations that "Scrushy was a central figure in the violations." The court also said that "a very preliminary peek at the merits might be appropriate" and faulted Scrushy for not presenting, in connection with his objection to the bar order, evidence that "he was merely an innocent bystander." The court said that it might look differently upon an "outside director who . . . was . . . an innocent bystander," but did not address the fact that the purpose of advancement is to give a corporate official the opportunity to prove his or her innocence. In reaching

its result, the court did not discuss the many Delaware cases that have held that directors and officers need not establish their lack of culpability in order to obtain advancement.

The implications of HealthSouth

Defending securities class actions easily can cost millions of dollars. Most directors and officers do not lose much sleep over the possibility that they will lose a securities fraud case, because they are conscientious about doing their job and about engaging competent professional advisers to help them. However, no amount of diligence or caution can ensure that a director or officer will not be sued.

If the HealthSouth ruling is followed by other courts, settling class action plaintiffs and corporate defendants will be able to extinguish advancement obligations. Even where a defendant corporation would be disposed to honor its advancement obligations, it will have to consider taking the same money-saving step as HealthSouth or be accused of corporate waste. Plaintiffs will be able to use the threat of extinguished advancement rights to increase their leverage in settlement negotiations with individual director and officer defendants. As a result, directors and officers will feel greater pressure to settle and pay damages—potentially out of their own pockets, if insurance policies have been exhausted—rather than risk paying millions in legal fees in an attempt to vindicate themselves.

What's next?

Time will tell whether other courts will follow the HealthSouth decision. Hopefully, other courts will find it unlikely

that the drafters of the PSLRA intended that it be used to relieve corporations of their obligations to advance defense costs—undermining the ability of directors and officers to defend themselves against the very kinds of lawsuits the PSLRA was designed to forestall.

The policy favoring advancement, though seemingly well-settled in the Delaware courts, has always had its detractors—especially where corporations find themselves paying millions of dollars in defense costs on behalf of former officials who, like Scrushy, are perceived to be wrongdoers. The offense that corporations and their shareholders feel in such circumstances often is made worse, because the officials may be found liable for an amount that exhausts their assets, leaving no money to repay advances. Accordingly, there is and likely will be continued pressure on the traditional advancement right.

It is also possible that the distinction suggested by the HealthSouth court—between an officer who is alleged to be centrally involved in a securities fraud and an outside director who is an “innocent bystander” (a curious choice

of words in an era in which directors are required to be more active than ever)—could become an accepted part of advancement law, allowing courts presiding over securities class actions to “peek” at the evidence, before the director and officer defendants have had a chance to mount their complete defense, and decide which of those directors and officers will have the expenses of putting on their complete defense advanced and which won’t.

Can anything be done?

While we wait to see how courts in other securities class actions will handle the inevitable efforts to extinguish advancement rights, there are at least some practical steps that directors and officers can and should consider taking now to address this development. Unfortunately, neither provides airtight protection.

First, in new or existing indemnification agreements, directors and officers should request a covenant by the indemnifying corporation not to seek or agree to a bar order that extinguishes the director’s or officer’s contractual right to advancement. Such a covenant

may not influence a court that, like the HealthSouth court, is willing to override an advancement obligation valid under Delaware law, but it could reduce the likelihood that a defendant corporation will seek such a bar order.

Second, a defendant director or officer may, at the first sign that the corporate defendant may not honor its advancement obligations, use the expedited procedures available in Delaware Chancery Court to obtain an order directing advancement. The existence of a state court order requiring advancement may give pause to the federal court presiding over the class action before it blesses a conflicting bar order.

Even with these mitigating steps, if the HealthSouth court’s view becomes widespread, uncertainty about the continued availability of advancement where a corporate defendant settles a securities class action will introduce another element of risk into service as a public company director or officer.

Robert F. Quaintance, Jr. and Colby A. Smith are partners with Debevoise & Plimpton LLP.

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who do not meet the independence test. Also, the unwillingness of CEOs to serve on other boards has created a challenge to assure that the board has directors with strategic business experience.

On the positive side, recent decisions of the Delaware courts have affirmed that the business judgment rule is alive and well in Delaware and that the standard for holding directors personally liable for employee failures remains high. D&O liability insurance rates for public companies have not increased appreciably, notwithstanding the increased litigation involving subprime and credit market losses.

Service as a director of a public company should, in our view, continue to provide an opportunity for a professionally rewarding experience. But, as we all know, it is time-consuming, laden with legal mandates, and exposed to reputational risk. This will demand that directors be fully informed about their responsibilities and devote the time needed to discharge them. Directors will need to seek ways to better communicate with their investors, will need to understand the initiatives of shareholder advisory organizations and media critics, as well as regulatory and legislative initiatives, and carefully evaluate appropriate board responses.

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Boards and Special Committees

By Karl D’Cunha

The role of Special Committees in dealing with the “Entire Fairness Standard”



Karl D’Cunha

Any corporate transaction involving an existing or potential conflict of interest may become the subject of litigation initiated by

minority shareholders. In such cases, directors may be called upon to prove that all aspects of the transaction were fair to the corporation and its shareholders. Directors may, however, be able to shift this burden of proof away from themselves and to the minority shareholders/plaintiffs if they have taken certain steps to ensure the fairness of the transaction. One important step is the establishment and use of a properly functioning Special Committee comprising independent and disinterested Board members empowered to negotiate the transaction.

A basic principle of corporate law is that the business and affairs of a corporation are managed by its board of directors. Courts have recognized that directors, acting on behalf of a corporation, have certain fiduciary duties to the corporation and its shareholders, including a duty of care and a duty of loyalty. In fulfilling these duties, directors must act “on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.” Where directors have done so, a court will not question the business judgment of the directors or otherwise second-guess the transaction. This is known as the business judgment rule, or the business judgment standard.

One exception to this standard occurs where the interests of the directors or a controlling shareholder conflict with those of the corporation or its minority shareholders. In that case, courts subject the transaction to a stricter standard. This stricter standard is known as the entire fairness standard and is best explained as follows:

Entire fairness

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock. However, the test for fairness is not a bifurcated one between fair dealing and fair price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.

Most corporate bylaws include provisions permitting the board of directors to create committees and specify their powers. In such case, a board need do little more than pass a resolution establishing the committee and describing its purpose, composition, powers, and duties. Where a corporation’s bylaws or articles of incorporation do not expressly include such powers, a board should consider amending one or the other to include this provision.

A Special Committee should consist of members of the corporation’s board of directors who are independent of the corporation and are disinterested vis-à-vis the contemplated transaction. In situations where no board members are independent, a company should consider adding additional outside independent board members who can also fill the role of Special Committee members.

The size of a Special Committee may be dictated by state statute, the corporation’s bylaws or articles of incorporation, or by the common law. The Model Business Corporation Act suggests that “each committee must have two or more members.” Under existing Delaware case law, a Special Committee may consist of as few as one director. The actions of a single member Special Committee, however, may be subject to extraordinary judicial scrutiny.

Once established, the Special Committee must focus on the task at hand—its job is not simply to complete the deal, rather, the Special Committee must ensure that the transaction will proceed only if it is favorable for the company and its shareholders. In order to do this, Special Committees generally utilize the advice of professionals in making this determination, including outside counsel and independent financial advisors. A committee’s first task, then, is to engage both legal and financial advisors.

The role of advisors

Special Committee members should review past and existing financial and business relationships between the proposed financial advisor and the controlling shareholder as well as the

corporation and any interested board members. It is not unusual for some investment banking firms who stand ready to provide fairness and other opinions to a Special Committee to have had recent dealings with either one or both parties to the proposed transaction, or to anticipate related (and lucrative) assignments as a result of the proposed transaction. In such cases, courts question whether a Special Committee has adequately represented minority shareholder interests. In addition, the Special Committee should not engage the corporation's own auditor to provide a valuation or a fairness opinion. To do so may compromise the auditors' independence under the SEC's recently revised auditor independence rules.

The committee's selection of legal and financial advisors may also be exposed to challenge. Courts question the fairness of a transaction where the Special Committee has altogether failed to engage a financial advisor. The entire fairness of the transaction is also suspect where advisors have been selected prior to the formation of a Special Committee, by persons other than Special Committee members, or by a dominant committee member.

Finally, the Special Committee should consider the financial advisor's fee structure. For most transactions, a contingent or success fee is not appropriate, since such a fee depends upon the success of the proposed transaction. This may compromise a financial advisor's independence, giving the advisor and its client a mutual financial interest in the success of the transaction. The advisor may have incentive to opine that the proposed transaction is fair, and be reluctant or decline to criticize the transaction in any way. Given the SEC's willingness to disqualify an auditor's independence in the presence of contingent fee arrangements, it is not difficult to imagine that courts, the SEC, or self-regulatory organizations would find a financial advisor's contingent fee



The Special Committee must ensure that the transaction will proceed only if it is favorable for the company and its shareholders.

structure or conflicting relationships to impair its independence when providing a fairness opinion. In this respect, Special Committee members are cautioned to ensure that a financial advisor is absolutely independent, and that they have no interest in the success of the proposed transaction through the fee structure or otherwise.

When engaging a legal advisor, the Special Committee should consider whether counsel is generally qualified in matters of corporate governance and specifically experienced in the type of transaction being considered. Special Committee members should also review past and existing financial and business relationships between the proposed legal advisor and the controlling shareholder as well as the corporation and any interested board members. The legal advisor should be expected to work with the Special Committee to set the committee's agenda and to guide the committee through legal issues that may arise. A legal advisor will also review and negotiate agreements governing the transaction. To the extent the corporation or the transaction is

subject to federal securities law, the legal advisor should draft or assist in the drafting of required disclosure documents and ensuring that all state, federal, and exchange-related filings or notices are made. Under most circumstances, communications between the Special Committee and outside counsel will be covered by the attorney-client privilege.

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Shareholder Nominations are Coming

By Douglas Raymond

Be ready for your shareholders to use your proxy statement to propose their own director nominees



Douglas Raymond

Proxy access, for better or worse, is coming. The controversial right of a shareholder to require a company to include in the

company's own proxy materials the shareholders' nominees for directors alongside the board's nominees is an issue that public company boards will have to address in the near future. While some of the details are still uncertain, it seems likely that we are entering a new world of proxy practice where shareholder nominees to a company's board will be an increasingly frequent part of the landscape.

Shareholders today have the right to nominate candidates for election as directors and then solicit proxies for them. However, currently they have to prepare and distribute their own proxy materials and may not piggyback onto the company's own proxy statement. This makes it a time-consuming and expensive task for a shareholder to promote director nominees in a proxy contest. And, since most shareholders are not that interested in proxy contests of any kind, a dissident suffers a marked disadvantage by being kept out of the company's official materials. Including shareholder nominees in the company's proxy statement would shift the cost of promotion from the shareholder to the company. Equally important, it would give election contests a greater imprimatur and likely lead to more victories for shareholder nominees.

Delaware's approach

While various proposals to grant this right to shareholders have been advanced over the years, the past year has seen a flurry of regulatory activity on the issue at both the state and federal level. Last August, the Delaware General Corporation Law was amended to allow (but not require) corporations to adopt bylaws granting shareholders the right to include their director nominees in the corporation's proxy materials. The amendment also allows a corporation to establish conditions to the shareholder's right of access to the proxy ballot, including minimum ownership thresholds and procedural restrictions.

Because these provisions are permissive and not mandatory, they provide Delaware corporations and their shareholders with flexibility to adapt their governance practices to their own particular circumstances. For example, a corporation could adopt bylaws granting shareholders access to the proxy ballot, but that impose conditions on a shareholder's exercise of that right. These conditions might include:

- a minimum level of stock ownership, measured by amount and/or duration of ownership;
- limits on the number of board seats available for shareholder nominations; and/or
- a requirement that the nominating shareholder provide information concerning it and its nominees, accompanied by an indemnity to the corporation for any losses as a result of any misleading statements in such information.

The SEC weighs in

Around the same time, in June 2009, the SEC proposed a new regulation that companies include in their proxy materials director nominees made by shareholders, for election to up to one-fourth of the entire board. Shareholders who owned as little as one percent of the shares for at least a year would have this right, subject to certain limitations. Shareholders could form groups to aggregate holdings to meet threshold requirements, but could not use these access provisions to seek a change of control. A company could exclude nominees of shareholders that did not meet the ownership and other eligibility criteria, but only in connection with a detailed process involving back and forth notifications between the company, the nominating shareholder and the SEC, potentially culminating in the need to request a no-action letter from the SEC to resolve the matter.

Unlike the Delaware provisions, the SEC rule proposals would have established mandatory and substantive provisions governing proxy access, and, if any proxy access rights granted under state law or company-tailored bylaw provisions were more restrictive than the federal rules, would have pre-empted those provisions. The SEC received hundreds of comments on its proposal and is now considering final rules.

Board concerns

So what should the board of directors be doing now to prepare their companies for the changes that appear imminent? How damaging will this be to effective corporate governance?

Predictably, the response to proxy access has been apprehensive. Most of the concerns expressed by critics have focused on the SEC proposals, which they view as unnecessary, arguing that there is no compelling evidence to suggest that the SEC's more intrusive mandatory approach would address the underlying issues more effectively than private ordering under enabling state laws (such as Delaware's). Critics also contend that the mandatory and pre-emptive nature of the SEC proposals represents an inappropriate realignment of corporate governance from the state to the federal level and would self-defeatingly undermine shareholder choice by denying shareholders the ability to opt out of the access regime in this form regardless of whether a majority of shareholders believe it is in the company's best interests.

Further, the diversity of corporate America is unsuited to the SEC's one-size-fits-all approach; even if proxy access would be beneficial for many companies, they argue, there are likely others for which it would have no beneficial or even adverse effects. Others have expressed concerns about various technical aspects of the proposed rules, such as the ownership thresholds and holding periods for nominating shareholders. Most troubling, however, are the concerns that single issue, special interest, or gadfly directors could interfere with or even immobilize proper board functioning, and disrupt the ability of the board to manage the corporation.

However valid these concerns, proxy access rights (in some form) are almost certainly coming. Therefore, maintaining an openly hostile position on principle is probably of little value and may damage relations with key shareholders. In any event, until the SEC's final rules are published and the definitive regulatory landscape becomes clearer, it seems premature to adopt defensive measures to blunt the impact of proxy access,

Boards may want to use the issue of proxy access as an opportunity to engage constructively with their shareholder constituencies.

particularly if such measures risk subsequent pre-emption as conflicting with those rules.

The strongest supporters of proxy access rights are, unsurprisingly, institutional and other large shareholders who would be most likely to exercise such rights. Many institutional investors have expressed frustration that their concerns are not sufficiently attended to by the boards of companies in which they invest. In their view, the enhancement of their ability to nominate and to remove directors will—regardless of whether or not they use this new access—act as a powerful incentive for communication and consultation between companies and their shareholders.

Possible board responses

Boards may want to use the issue of proxy access as an opportunity to engage constructively with their shareholder constituencies. For example, management or directors could have discussions with their principal shareholders regarding the board nomination process, including an ongoing dialogue around shareholder concerns. Indeed, board success in maintaining positive relationships with large investors may forestall shareholder requests to include nominees in the company's proxy materials at all.

Today, there is substantial question as to whether proxy access will improve corporate governance. If the mandatory provisions proposed by the SEC take effect to the exclusion of more flexible proxy access regimes like that in Delaware, boards of public companies will likely face a number of practical headaches. Particularly in the beginning this will

cause problems as various uncertainties in the technical aspects of the proxy process are ironed out. Companies may likely see an increased number of proxy contests arising from proxy access nominations. A successful proxy contest can also raise troubling internal board governance issues, such as the potential election of "special interest" or single-issue directors having goals inconsistent with maximizing long term shareholder value; or the possibility that such an election may create excessive conflict among directors or cause divisions in the board room, with the resulting distrust and disruptions undermining the board's ability to govern effectively.

Many boards will undoubtedly seek to mitigate the most troubling of these potential issues (including by establishing stricter independence and confidentiality requirements for directors vis-à-vis their nominating shareholders to manage the influence of "special interest" directors). However, it is probably premature to take significant steps until the precise scope of the final rules is known. Nevertheless, there are several matters that boards might consider now, especially reviewing the company's advance notice bylaws to ensure that the nomination and election procedures allow sufficient time to address potential shareholder nominations, and determining how a contested election arising as a result of shareholder proxy access would play out under the company's voting procedures, whether plurality or majority voting.

Doug Raymond is a partner in the law firm Drinker Biddle & Reath LLP and heads the firm's Corporate & Securities Group. He can be contacted at doug.raymond@dbr.com. Charles Farnsworth, an associate with Drinker Biddle & Reath, assisted in the preparation of this article.

Directors & Boards'

2009 Top Corporate Governance Law Firms



Directors & Boards presents its third annual ranking of top law firms specializing in corporate governance issues. These rankings represent the unaided responses from 314 respondents to our legal services survey, which was conducted in September 2009.

We asked directors to name up to three law firms which they felt were best in each of the following categories: general corporate governance issues, director liability, board level and board level M&A.

Because of the broad base of governance professionals represented in our database, this year we chose to build this list solely by choosing the responses of public and private company directors. This decision resulted in some serious changes to the rankings, but reflect, we think, the broad consensus of board members.

The top 10 responses in each category are presented here.

Best in Dealing with General Corporate Governance Issues

2009 Rank	2008 Rank	
1	1	Skadden Arps Slate Meagher & Flom
2	3	Wachtel Lipton Rosen & Katz
3	4	Gibson Dunn & Crutcher
4	8	Debevoise & Plimpton
5	6	Jones Day
6	5	Weil Gotschal & Manges
7	NR	Cravath Swain & Moore
8	9	Ropes & Gray
9	NR	Sullivan & Cromwell
10	10	Drinker Biddle & Reath

Best in Dealing with Director Liability Issues

2009 Rank	2008 Rank	
1	2	Wachtel Lipton Rosen & Katz
2	1	Skadden Arps Slate Meagher & Flom
3	4	Holland & Knight
4	NR	Sullivan & Cromwell
5	NR	Simpson Thacher & Bartlett
6	7	Debevoise & Plimpton
7	NR	Jones Day
8	6	Gibson Dunn & Crutcher
9	NR	Clifford Chance
10	NR	Morrison & Foerster

Best in Dealing with Board Level M&A Issues

2009 Rank	2008 Rank	
1	2	Wachtel Lipton Rosen & Katz
2	1	Skadden Arps Slate Meagher & Flom
3	NR	Debevoise & Plimpton
4	3	Simpson Thacher & Bartlett
5	NR	Weil Gotschal & Manges
6	6	Sullivan & Cromwell
7	NR	Jones Day
8	NR	Cooley Godward Kronish LLP
9	NR	Holland & Knight
10	6	Cravath Swain & Moore

*Survey Conducted September 2009; 314 Respondents
Unaided recall; director responses only.*

The Directors & Boards Survey: Legal Services

Methodology

This **Directors & Boards** survey was conducted in September 2009 via the web, with an email invitation to participate. The invitation was emailed to the recipients of **Directors & Boards'** monthly e-Briefing. A total of 314 usable surveys were completed.

About the respondents

(Multiple responses allowed)

A director of a publicly held company	50.8%
A director of a privately held company	56.6%
A director of a non-profit entity	49.2%
A senior level executive (CEO, CFO, CxO) of a publicly held company	14.8%
A senior level executive (CEO, CFO, CxO) of a privately held company	31.1%
Institutional shareholder	6.6%
Other shareholder	28.7%
Academic	5.7%
Auditor, consultant, board advisor	20.5%
Attorney	19.7%
Investor relations professional/officer	2.5%
Other	2.5%

Revenues

(For the primary company of the respondent)

Average revenues:	\$1.91 billion
Less than \$250 million	54.1%
\$251 million-\$500 million	9.0%
\$501 million to \$999 million	8.2%
\$1 billion to \$10 billion	23.0%
More than \$10 billion	5.7%

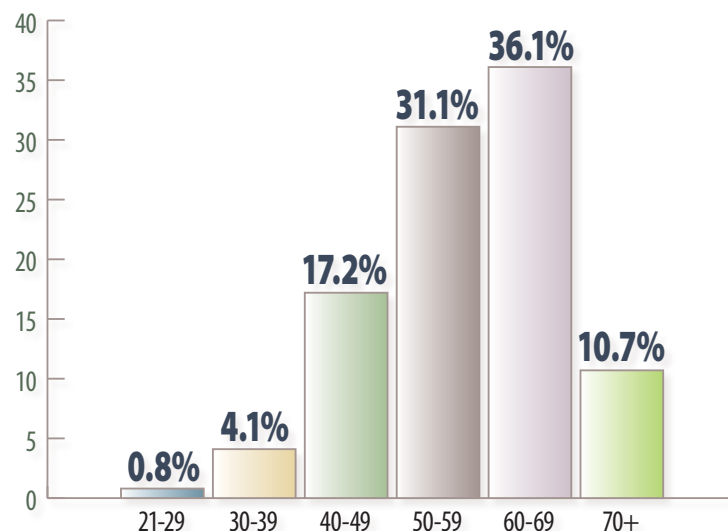
Board Service

(Average number of boards respondents serve)

Public	1.39
Private	2.10
Charitable	1.77

Respondents' Age

Average Age: 57.4

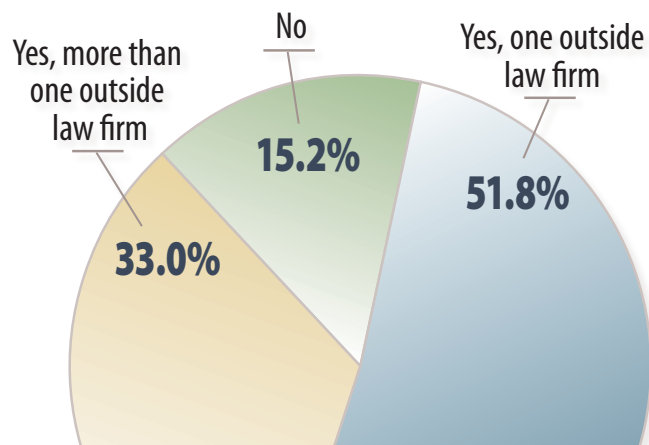


Legal Counsel and Boards

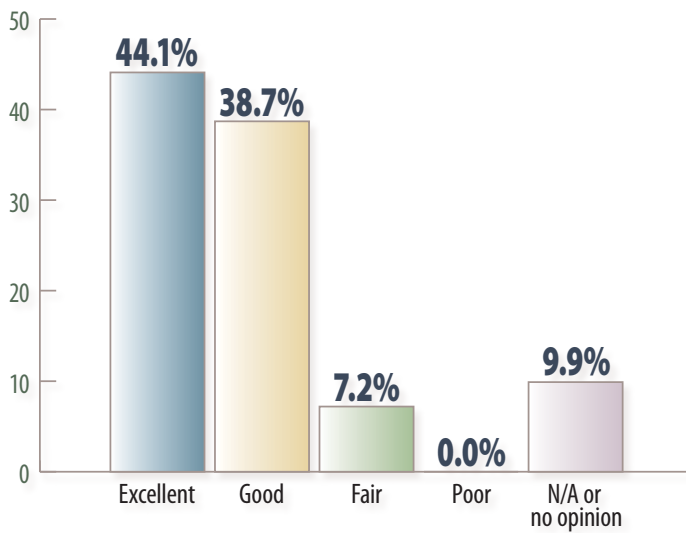
Does your primary board's company employ a full time general counsel and/or legal team?

Yes, General Counsel	20.4%
Yes, General Counsel and full legal team	29.2%
No	49.6%
Other	0.9%

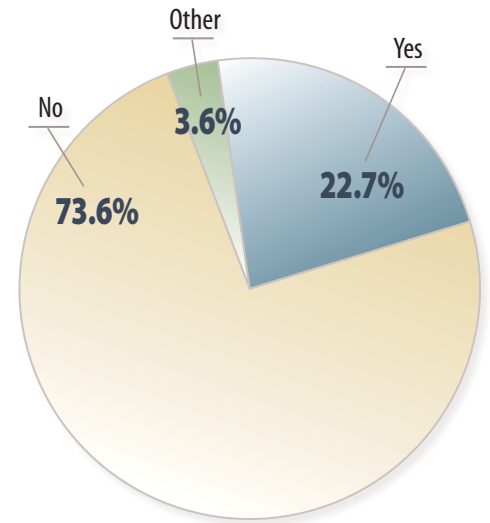
Does your primary board's company retain outside counsel?



Please rate this outside law firm(s) on its ability to meet your corporation's legal needs.



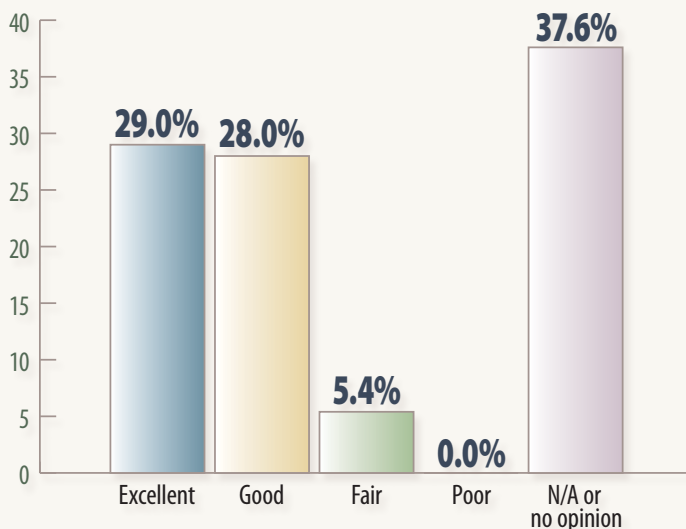
Are any cost or other limitations placed by your primary company on the use of ad hoc or dedicated outside counsel by the board?



Does your board retain outside counsel fully independent of your primary company and its management?

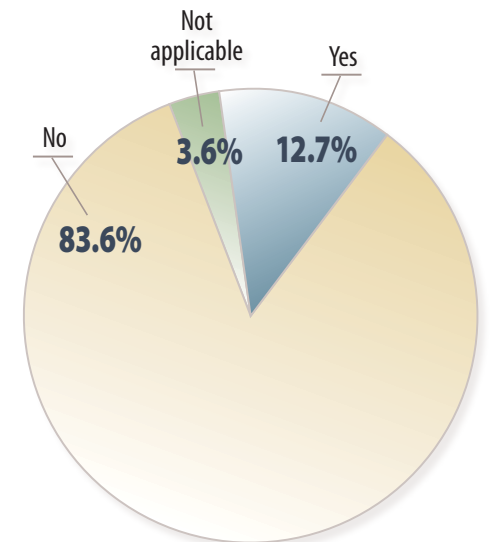
Yes, one outside law firm is on retainer to the board	33.0%
Yes, more than one outside law firm is on retainer to the board	5.7%
No	61.3%

Please rate this outside law firm(s) on its ability to meet your board's legal needs.

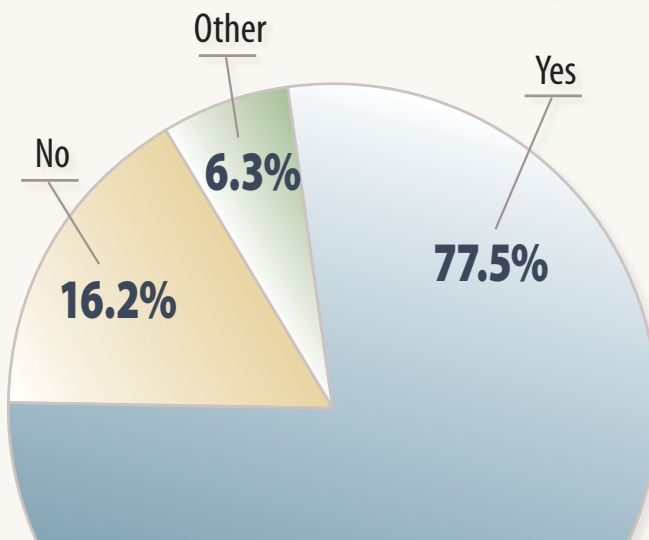


Legal Counsel and Directors

Do you personally, as a director, retain counsel to represent you in matters relating to your board service?



Is your board able to select your outside counsel completely independently of your primary company and its management?



If yes, are the fees for this personal counsel:

Reimbursed fully by the corporation	9.9%
Reimbursed partially by the corporation	4.2%
Paid for by you personally	9.9%
Do not retain personal counsel for board matters	76.1%

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And we share a common vision: to provide exceptional legal service focused on your goals.

For more information, visit us at www.drinkerbiddle.com.

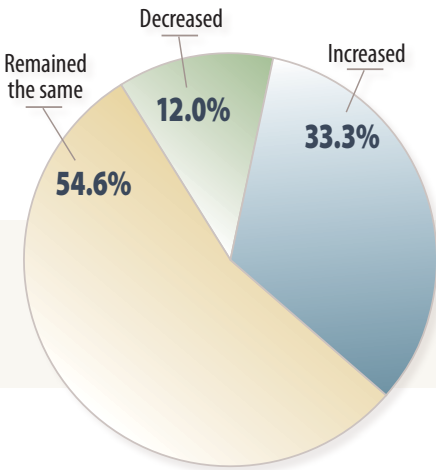
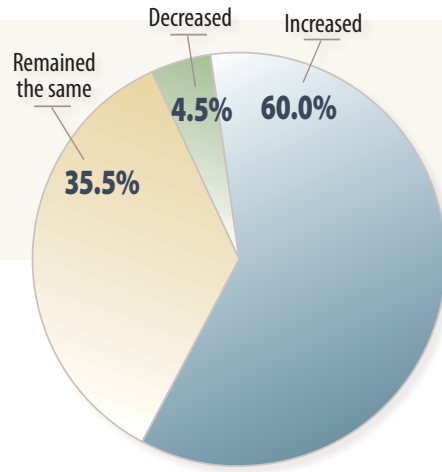
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Do you feel that the requirement for personal independent outside counsel for directors over the past three years has increased, decreased, stayed about the same?



In the past year, has the frequency of shareholder lawsuits increased, decreased, stayed about the same?

Choosing Legal Counsel

For the following types of counsel, how long in years has your primary law firm provided services to your company, board or to you?

Corporation's outside counsel, years:	10.47
Board's outside counsel, years (if applicable):	4.13
Your personal counsel for board-service related issues, years (if applicable):	2.29

Have you or your board changed counsel or retained new counsel in the past year?

Yes, changed counsel	8.4%
Yes, retained new counsel in addition to current counsel	10.3%
No	81.3%

How often does your board consider retaining new law firms?

Never	11.2%
When we need specialized expertise	77.6%
On a regular basis	8.4%
Other	2.8%

In considering law firms for service to your board or you, what do you look for in those firms?

(Multiple responses allowed.)

Reputation of firm	76.6%
Experience with board work	72.0%
Recommendations of/experiences of people I trust	68.2%
Experience with public companies	54.2%
Potential cost of using the firm	49.5%
Experience of senior partner	49.5%
History of results	47.7%
Active presence of senior partner	45.8%
Published articles and thought leadership content	9.3%
Other	11.2%

Director Comments

If you could change one or more things about the legal services provided to your board or to you as a director, what would that change or changes be?

Law firms need to stop nickel and diming us to death with urgent advisories that are a code for requesting a consultation—we'll call you when we want to start the clock!

We need more independence from senior management regarding the selection of legal counsel.

I suggest a counseling charge reduction for firms with vested interest (acting to safeguard the interest of a particular director).

Law firms should provide more access to specialists when unusual issues develop.

Don't hire a firm unless it is a flat rate. The legal industry needs regulation. Self-regulation is not working.

Public companies with more than \$1 Billion in revenues or market cap should be required by law to retain a separate and independent counsel for the board's independent directors.

We need more frequent updates on litigation affecting corporations, not just our own litigation.

Law firms should charge a flat rate for scheduled board meetings and related activities for the year.

Provide less "legalese" and more common English explanations.

Show more "teeth" in frivolous lawsuit situations.

More senior partner time and attention. We do not hire firms because of their young lawyers

I'd like law firms to be more proactive in providing ways to increase shareholder value versus just focusing on defense and compliance.

Provide cleaner/clearer distinction between legal and business advice.

Executive Compensation Risk Management

By Michael Dunn and Charles Modlin

Strategies for an evolving regulatory landscape



Michael Dunn

Risk management oversight at the board level historically has focused on minimizing exposure to potential criminal or civil liability. Companies have developed corporate compliance programs consistent with the seven point framework for an effective compliance program



Charles Modlin

articulated in the U.S. Sentencing Guidelines with an emphasis on prevention, detection and remediation of improper conduct and promotion of full and complete compliance with applicable disclosure laws. Although the audit committee is responsible for risk management policies and procedures under most compliance programs (and NYSE listing standards require the audit committee to have such authority), management retains broad discretion and authority to assess and manage exposure to business risks, including as it relates to incentive compensation for non-executive employees.

As Congress, the Treasury Department and the SEC act to stimulate the economy and address the unprecedented turmoil in the capital markets, executive compensation practices that are deemed to have encouraged excessive or inappropriate

risk have been at the center of public debate. Federal regulators and lawmakers have responded by adopting or proposing a series of measures that target the assessment of compensation policies and packages as a significant component of financial risk management.

Five principles

The Treasury Department has identified five broad-based compensation principles that companies should consider to align compensation practices with the interests of shareholders:

- Compensation plans should properly measure and reward performance;
- Compensation should be structured to account for the time horizon of risks;
- Compensation practices should be aligned with sound risk management;
- Companies should re-examine whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders; and
- Companies should promote transparency and accountability in the process of setting compensation.

The principles state that compensation committees should align compensation practices with sound risk management by conducting and publishing risk assessments of pay packages to ensure that they do not encourage imprudent risk taking. A compensation package would be properly structured under the principles if it is determined that the package has been appropriately customized to create

an incentive for the employee to achieve a balanced mix of the company's overall long-term and short-term goals.

In conducting a risk assessment of a compensation package, a compensation committee should consider several questions, including:

- Does a particular business unit account for a significant portion of the company's risk profile?
- Is the compensation of a particular business unit structured significantly differently from that of other units?
- Is a particular business unit significantly more profitable than other units?
- Does the compensation expense of a particular business unit represent a significant percentage of the company's revenues?
- Does the compensation package vary significantly from the company's overall risk and reward structure, such as when the timing for performance-based bonuses or incentive awards occurs significantly before receipt of anticipated income or expiration of associated risk to the company?

Proposed rules

The fundamental considerations at the heart of these questions form the basis of pending SEC rule proposals that, in certain circumstances, would expand current disclosure rules to require companies to address compensation of all employees and not just the most highly compensated executive officers in certain circumstances.

The proposed rules would require a company to articulate how its overall compensation for all employees creates incentives that may impact the company's risk management. A compensation committee would need to consider and disclose on an annual basis the level of risk that employees may be inclined to take in order to satisfy the incentive-based elements of their compensation packages. In addition, proposed Congressional legislation would require every public company to submit executive compensation packages to shareholders for an annual, non-binding vote.

This pending say-on-pay legislation, the SEC rule proposals and the Treasury principles could, in effect, transfer responsibility for financial risk assessment, at least as it relates to compensation matters, from management to the compensation committee and shareholders. This transition will require a company to re-evaluate its risk management policies and procedures and to implement a new compensation risk assessment framework with significantly more involvement from the compensation committee, which will be responsible for evaluating compensation risk for all employees, not just senior executives.

A board should immediately begin to assess what steps it will need to take to effectively empower its compensation committee to discharge its duties under the evolving regulatory landscape. The board should begin by evaluating its compensation risk assessment framework, including whether the charter of its compensation committee needs to be amended to adequately address the scope of the committee's expanding responsibilities. For NYSE-listed companies, this may require the compensation committee to report to the audit committee in connection with the audit committee's financial risk management responsibilities. A company should also consider whether the members of its compensation committee are knowledgeable enough to understand the interaction between

performance goals, executive behavior, risk management and shareholder value. The compensation committee should have the authority and resources to engage independent professionals who can provide the committee with adequate and current information on all of these topics.

Larger companies with established finance, HR and legal departments should consider establishing a compensation risk assessment (CRA) committee consisting of representatives from each of these departments. The CRA committee would report directly to the compensation committee in the same way that a disclosure committee reports to the audit committee. The CRA committee would be charged with overseeing risk assessments, evaluating risks associated with the company's compensation programs, and identifying the features of compensation programs that could promote excessive short-term or long-term risks. The chair of the CRA committee would be responsible for making recommendations to the compensation committee, including changes to performance goals, compensation levels or the mix of various types of compensation.

Compensation philosophy

After a company has implemented or revised its risk management framework, it should consider its overall compensation philosophies and goals in light of the new regulatory landscape. These considerations should include, at a minimum:

- Moving away from single performance metrics based on stock price, EPS or EBITDA in favor of a broader range of multiple performance measures and a variety of programs which create balance in compensation design;
- Evaluating existing employment, severance, change in control, and tax gross-up agreements to determine whether they are so generous that they encourage risky behavior;

- Adopting the use of dynamic tally sheets to model probable as well as unlikely business scenarios;
- Clearly identifying long-term and short-term financial goals; and
- Assessing the adequacy of the size and composition of its peer group and whether and how the company's operations or business strategy differ from those of the peer group.

As companies work to evaluate and revise their compensation risk strategies, it is important to remember that there is no one-size-fits-all solution. A board should not wait until final regulations are in place to begin to address these issues. Every company faces unique challenges based on its industry and specific operations that will require it to analyze its compensation risks in different ways. However, through an effective framework with clearly defined policies, procedures and roles for specified participants, a company will be well-equipped to effectively adopt and maintain risk management strategies that reflect today's best practices.

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Charles Modlin is a partner in the Corporate & Finance Practice Group of Seyfarth Shaw LLP and co-hiring partner of the New York office. He advises private and public companies on day-to-day operations, strategic corporate initiatives, mergers and acquisitions, corporate restructurings, financings, capital market transactions, and financial institutions in a wide variety of matters, including in respect of their lending activities. He also works with companies in restructuring their balance sheets, and negotiating with lenders and other stakeholders in respect thereof. He can be reached at cmodlin@seyfarth.com

Board and Management Succession Planning

By Steven W. Vazquez and Evelyn Dilsaver

Key issues for boards to consider when addressing succession planning.



Steven W. Vazquez



Evelyn Dilsaver

The CEO, senior corporate officers, and board members typically possess a valuable combination of intelligence, skills, and experience. Because they play important roles in a corporation, their loss can have a major impact on the corporation's short-term operations and long-term prospects for success.

Management succession planning

Boards of directors have a fiduciary duty to address business risks to which the corporation may be exposed, including the inevitable loss of senior corporate officers. Addressing losses on an ad hoc basis can prove unwise and costly. Without proper planning, boards often find it exceedingly difficult quickly and effectively to attend to tasks associated with replacing a senior officer, including:

- Assigning executive search functions to committees or external recruiting firms;
- Identifying qualified candidates to succeed the departing officer;
- Interviewing and negotiating with candidates;

Boards might require directors above age limits to tender resignations annually, but leave boards the option to accept or reject resignations.

- Communicating the officer's departure to the corporation's constituents; and
- Addressing administrative and legal matters, including securities filings.

Following are key issues for boards to consider, and ideas for overcoming obstacles boards may encounter during management succession.

Identify company insider successor candidates

Many boards find company insiders better suited than outsiders to succeed senior officers. First, the board can readily interact with company insiders to determine whether they possess the requisite intelligence, professional and interpersonal skills, and understanding of relevant markets and the corporation's business plan. Second, company insiders are familiar, and presumably compatible, with the corporation's culture. Third, the corporation's other employees will be familiar with, and likely comfortable, working with insiders.

In order to identify and groom company insiders to succeed senior officers, boards should get to know up-and-coming executives at the organization. Regular interactions over time such as dinners, presentations and retreats help the board get to know the candidates in an unstructured setting. Candidates should be provided with feedback to understand their strengths and areas for improvement.

Reduce the plan to writing and review regularly

It is a good idea to put the management succession plan in writing because when needed, it will be difficult to describe the plan orally in an accurate manner. A well-written management succession plan accounts for a variety of scenarios and issues.

The board of directors should, at the very least, review the plan annually. A review should consider whether the plan needs revision in light of any changes to the corporation's business strategy. The board might review the list of potential successors and determine whether they remain viable candidates. The board also might revise the qualities and skills they seek in senior officers in response to market changes.

Added difficulties with founder-based boards

Founder-based boards frequently have a difficult time during CEO succession. Often the founder is the only individual with the skill-set necessary to grow the organization, and preparing for change in senior officers is an emotionally difficult process.

Founder-based boards can circumvent these difficulties by delegating responsibility for the management succession plan to a committee of independent directors.

Sometimes a founder-based board must address the situation where the company

has outgrown the founder or CEO, to the point that person can no longer do the job effectively. When asking that current CEO to step down, it is essential for the board of independent directors to have a unified position on long-term development.

The co-CEO approach

Although unconventional, co-CEOs can be an effective structure for management transition. One scenario is a retiring CEO who is willing to mentor a co-CEO as the eventual replacement. Another less common scenario is two internal candidates with different skill sets who complement each other well operating as co-CEOs.

Board succession planning

Selecting individuals to sit on the board of directors is just as important as selecting senior officers. Directors must be intelligent, understand the strategic business plan and relevant markets, and work well with other board members. Much like identifying management successors, identifying director candidates is best accomplished through a detailed and regularly-reviewed board succession plan.

Identify desirable director qualities and skills

The first step in board succession planning is identifying desirable director qualities and skills. The board should review the current directors' professional skills in light of the strategic business plan and determine what, if any, deficiencies exist. The board should ensure that multiple directors possess desired professional skills—redundancy allows the corporation to sustain the loss of directors without losing core characteristics. Additionally, if the board maintains specialized committees (e.g., an audit committee), redundancy permits the corporation to rotate committee chairs.

While maintaining a depth of critical skills, the board must look for candidates who offer diverse experience. For example, the board should consider whether a candidate's background makes

him or her well-suited to speak for an underrepresented class of stakeholders, or whether a candidate's gender or ethnicity offers viewpoints currently underrepresented on the board.

Consider external recruiting firms

Approximately 80 percent of board seats are filled by friends or associates of directors and senior officers. This practice may foster collegiality, but also may compromise director independence.

Boards that need to fill board seats with independent directors should consider enlisting an external recruiting firm. Recruiting firms conduct extensive due diligence of director candidates, which can assuage director and senior officer fears of filling a board seat with an unknown. Recruiting firms can interview directors and officers, assess board dynamics, and tailor the search based on identified skills and qualities in line with the strategic business plan.

Be honest with director candidates

The board of directors should be honest with director candidates about the corporation. Issues may arise between the corporation's engagement in sensitive or confidential activities and full disclosure to candidates. For example, during merger negotiations, a board may be prohibited from disclosing the negotiations under a nondisclosure agreement. Additionally, boards may consider whether negotiations have reached a stage of reasonable likelihood that the parties will close the transaction, and whether to disclose the negotiations to all, some, or none of the candidates.

A board might also want to protect the confidential or sensitive nature of its engagements through its own nondisclosure agreement.

Consider director age limits

Approximately 80 percent of S&P 500 companies have adopted director age limits, which typically compel directors to resign upon reaching 70 to 72 years of age.

Forcing directors to tender their resignations upon reaching a specified age may be useful insofar as it gives boards "cover" to remove underperforming directors with minimal confrontation. On the other hand, a board member's performance does not necessarily correlate to their age. For instance, retiree directors can fill critical board roles, often spending more time on their duties than directors with full-time jobs.

To lessen this risk of arbitrarily losing a valuable board member, a board might consider limitations subject to waiver. For example, boards might require directors above age limits to tender resignations annually, but leave boards the option to accept or reject resignations. Or the board might permit directors above age limits to retain director titles and attend board meetings, but prohibit them from casting votes. The board also might require directors above age limits to tender their resignations, then hire them as consultants.

Consider director term limits

Like age limits, term limits risk the loss of valuable board members. Term limits may also inhibit the development of close ties between directors, corporations, and other board members.

However, term limits can ensure the board is regularly infused with fresh perspectives. And although time may foster close ties between directors and the corporation, those ties can potentially encumber the directors' ability to exercise independent judgment in evaluating officer performance and managing the business affairs of the corporation.

Prepare for changes to a director's primary employment

When directors change their primary employment, they may no longer be able to fulfill director duties. Moreover, the interests of a director's new employer may be directly or indirectly adverse to the corporation's. Thus, changes in

(continued on page 54)

Early Dismissal

By Leo G. Rydzewski

The Supreme Court's further tightening of procedural rules means that corporate defendants may secure early dismissal of lawsuits.



Leo G. Rydzewski

You're the CEO or director of finance for a publicly-traded company. You receive a call from your General Counsel, who reports that

the company has been sued and that the plaintiff is seeking to take very expensive discovery of the company's electronic information, including your emails. From your General Counsel's description of the case, it sounds like another fishing expedition in which the plaintiff has raised very general factual allegations and recited only the basic elements of a claim. You believe that the case has no merit but, nonetheless, the company will need to weigh two equally-unappetizing choices: the costs of defense (including the substantial costs of discovery) against the costs of entering into an early "nuisance value" settlement and the payment of some funds to plaintiff's counsel.

Now there is a viable third option. In two recent cases, including one decided earlier this year, the Supreme Court has given new "teeth" to the procedural rules governing what facts a plaintiff must allege to gain access to the courts, giving defendant much greater prospects of an early dismissal. In the past, a plaintiff could proceed with litigation so long as the complaint placed the defendant on "notice" of the claims and there were "no set of facts" on which plaintiff would be entitled to relief. Now, however, plaintiffs no longer will be able to proceed by alleging the elements of a cause of action

or making unsubstantiated conclusions. Instead, trial courts must scrutinize the allegations raised in the complaint to determine whether they are based upon facts and not mere conclusions, and whether the well-pleaded facts are sufficient to establish that the claim is "plausible on its face." This new standard gives defendants a much greater chance of having the case dismissed shortly after it is filed, before undertaking any expensive discovery, and without making a settlement payment to plaintiff's counsel.

Lurking behind the Supreme Court's new heightened standard is a concern over the increased costs of discovery and the prospect of requiring companies to spend their time and money on discovery when the complaint fails to identify specific facts showing that they are culpable. Litigation is expensive, both in time and money. Through these decisions, the Court is taking additional steps to better ensure that a plaintiff has a viable case before proceeding to impose those costs upon others.

The new "plausibility" pleading standard

The Supreme Court dropped a "bombshell" on the legal community in 2007 when it announced, in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), that a new standard would govern the filing of civil complaints in federal court. *Twombly* was a massive putative class action lawsuit in which plaintiffs—ninety percent of all telephone or high-speed internet access subscribers—alleged that the country's largest telecommunications providers unlawfully agreed not to

compete with one another. In dismissing the case, the Supreme Court announced that a complaint must allege enough facts to state a claim to relief that is "plausible on its face." To be plausible, the complaint must allege facts sufficient "to raise a reasonable expectation that discovery will reveal evidence" of illegality. Facts that are "merely consistent with" a defendant's liability also are insufficient. Under this new standard, the Court found plaintiffs' allegations deficient because they had alleged only legal conclusions, and the facts as alleged did not plausibly suggest illegality because there was a more likely explanation that was entirely legal. The case was over shortly after it had begun.

In *Ashcroft v. Iqbal*, 129 S.Ct. 1937 (2009), the Supreme Court greatly expanded upon the "plausibility" standard. The Court in *Iqbal* held that before allowing a plaintiff to proceed with discovery in federal court, a trial court must use its "judicial experience and common sense" to determine whether the allegations raised in the complaint are facts that the court properly may consider, or mere conclusions that the court may disregard. The court's second-guessing of a complaint's factual allegations is a significant development that presents defendants with another basis for securing the early dismissal of a lawsuit.

The dispute arose after Javaid Iqbal, a Pakistani Muslim, was arrested after the September 11, 2001, terrorist attacks. Iqbal sued a host of federal officials, including former Attorney General John Ashcroft and FBI Director Robert Mueller, alleging that they discriminated

The court is striking a balance between an open court system that gives plaintiffs the opportunity to present their claims, and an efficient system that does not saddle defendants with frivolous litigation and unnecessary costs.

against him because he is an Arab Muslim. The Supreme Court held that Iqbal had simply recited the elements of a discrimination claim; furthermore, the factual allegations did not plausibly suggest an entitlement to relief because there is “no surprise” that the post-9/11 detention policy would produce a disparate, incidental impact on Arab Muslims, given that the September 11 attacks were perpetrated by Arab Muslim members of Al Qaeda. The Court found an “obvious alternative explanation”—a “nondiscriminatory intent to detain aliens who were illegally present in the United States”—and as between that “obvious alternative explanation” and Iqbal’s claims, “discrimination is not a plausible conclusion.” Iqbal’s case was dismissed before he could take any discovery.

The Court strikes a new balance

In tightening the procedural rules governing the filing of civil complaints in federal court, the court is striking a balance between an open court system that gives plaintiffs the opportunity to present their claims, and an efficient system that does not saddle defendants

with frivolous litigation and unnecessary costs. This balance involves two kinds of risks: the risk that a plaintiff with a meritorious case will be unable to proceed, and the risk that a plaintiff who does not have a meritorious case will be allowed to impose substantial costs upon the defendant through the discovery process. With *Twombly* and *Iqbal*, the balance has shifted in favor of the defendant. As the Court noted in *Twombly*, because “the threat of discovery expense will push cost-conscious defendants to settle even anemic cases,” the Court will require sufficient factual allegations to ensure there is a “reasonably founded hope that the discovery process will reveal relevant evidence” to support a claim.

The rulings will have a significant impact on litigation practice. Plaintiffs will need to draft longer complaints that provide factual details supporting each element of a cause of action, including damages. In many cases, plaintiffs will need to conduct additional pre-suit factual investigations to gather the information that the trial court will require. The new plausibility standard, coupled with the requirement that a plaintiff allege facts and not merely

conclusions, will do more to ensure that federal courts will dismiss lawsuits where the plaintiff has not undertaken the work to develop supporting facts. Given the substantial cost of discovery, more defendants will need to consider filing motions seeking to dismiss complaints at the outset of the case, before discovery begins. In commercial business disputes involving corporations and high-level business executives, defendants have a new means of addressing “frivolous lawsuits” that in the past have caused many defendants to pay substantial sums to settle cases, not on their merit, but simply to avoid the substantial costs of litigation. If the trial courts vigorously apply the new standard to dismiss lawsuits that lack supporting facts, then the decision will have far-reaching consequences for business executives who are looking for a “new way” to resolve litigation without encouraging new lawsuits through the payment of “nuisance” settlements.

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a director’s primary employment may necessitate the director’s removal from the board, and boards should plan for these employment changes.

Boards may struggle to decide on removal, so rules governing changes to a director’s primary employment are useful. Some corporations require directors to resign upon a change in primary employment. Other corporations require directors to tender their resignations to nominating committees, which recommend the board either accept or reject the director’s resignation. Such rules provide notice to directors that changes in their employment may result in removal from the board.

Secondarily, these rules can give directors cover for removing a board member, again ensuring the board is composed only of individuals capable of fulfilling their duties.

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