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Spring Training '09: Nine Players and Nine Issues to Watch for in the Upcoming Proxy Season

NATIONAL DIRECTORS INSTITUTE

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Issues for Your Board to Consider During Economic Stress

On January 28, 2009, Foley & Lardner LLP presented "Issues for Your Board to Consider During Economic Stress" as part of its National Directors Institute — 2009 Web Conference Series. Foley Transactional & Securities Partner Steven R. Barth led the discussion along with Timothy Hanley, Vice Chairman, U.S. Process & Industrial Products Leader for Deloitte & Touche LLP.

Boards of directors are facing unprecedented challenges in the current economic environment. Many historical governance practices upon which boards have traditionally relied may no longer be appropriate or adequate. The widespread perception that undue risk-taking caused the credit crisis that led to the country's recessed economy has prompted many to question the integrity of board oversight. In this economic climate, it is critical for a board to evaluate its governance practices and identify areas that require adjustment or enhancement to best position the company to manage current unprecedented challenges as well as unexpected future challenges. Any such evaluation should include the following considerations:

Make Risk Oversight "Priority One"
In light of increased public concern about excessive risk-taking at public companies, the board should renew and intensify its focus on enterprise risk assessment. A comprehensive assessment should extend to all areas of the enterprise, including information technology (IT) systems and legal and regulatory oversight and compliance. The board must determine whether the company has adequate risk-monitoring systems in place or whether those systems need to be strengthened. Enhanced risk management should include (1) review of internal controls, including documentation and audit of the effectiveness of the review; (2) review of accounting policies and transparency, including a review of competitors' practices; (3) review of off-balance sheet risks, particularly contingent liabilities; and (4) review of disclosure controls. The company's disclosure committee must be active and engaged in risk management and should include all of the key players at the company who understand the macroeconomic and microeconomic drivers of and threats to the company. Finally, the board should review the company's code of conduct and ensure that employees understand its provisions and the reporting process.

Understand Key Risks
All companies face risks that are specific to their enterprises and their industries. The board must understand and be able to assess the key risks and threats to the company, its strategy, and its segments, divisions, and/or subsidiaries. As needed, the company's general counsel can help the board fully understand key risks to and macroeconomic drivers of the business. The board should be able to evaluate the company's strategic plan, initiatives, goals, and objectives in light of those risks and drivers.

Identify Early Warning Signs
If a company is not paying attention, it can miss early indications that internal or external risks are developing. The board should ensure that the company has adequate monitoring systems in place that will allow the management team and the board to identify early warning signs, including key risk indicators in the industry. The board also should pay close attention to the soundness of the company's balance sheet, especially significant contingent liabilities such as judgmental reserves and warranty, environmental, tax, litigation, regulatory, pension funding, and asset impairment exposure. The board also should take note of any failure of a significant stakeholder (e.g., a supplier), which could have a detrimental effect on the company's operations.

Establish Clear Responsibility for Risk Management

With the increased importance of risk oversight, many companies are evaluating where to house the job of overseeing and addressing enterprise risk. The board should consider whether risk management should be the responsibility of the entire board, a special risk-management committee, or an existing standing committee (e.g., the audit committee or the corporate governance committee). Alternatively, the board could appoint a chief risk officer to manage the company's risk oversight, with direct reporting responsibility to the board or a designated committee.

Utilize Outside Resources

Independent resources can be a valuable source of information for companies' risk managers. The board should include in its risk-oversight function the consideration of risks identified by outside resources that have evaluated the company and its industry. The board also should be aware of what equity analysts, rating agencies, and the press are saying about the company and its competitors. Board members should know the company's rating agency review cycle, which may affect how the company can borrow and at what cost. Independent financial advisors, outside counsel, and industry experts who understand the macroeconomic drivers of the industry and how they impact the company's business are particularly useful and important to substantiate that the board is satisfying its fiduciary duty of care.

Coordinate Risk-Management Efforts

Risk-management efforts between the board (or board committee) and the company's chief risk officer (if any), general counsel, internal audit team, disclosure committee, and senior management should be closely coordinated. The individuals and teams charged with risk management should clearly identify their respective responsibilities for monitoring key risks and mitigating them as appropriate. Such coordination may be appropriate at different levels of the company, depending on the company's relative size and complexity.

Evaluate the Management Team

Investor trust and confidence in management is more important than ever in today's economic environment. The board should evaluate whether the company has the right management team in place to deal with the current economic challenges. Until recently, many management teams primarily comprised individuals who were hard-charging, entrepreneurial, and willing to take risks. That management style may not be appropriate in the current environment. The board should examine the temperament of the company's senior management and consider whether those individuals inspire trust from investors and within the company. The company's "tone at the top" must emphasize integrity, ethics, transparency, long-term fundamentals, balance sheet integrity, and conservative capitalization, and management must be forthright in communicating with investors and within the company.

Evaluate How Best to Maximize and Preserve Liquidity

As is widely understood, over-leverage has been a primary cause of the current credit crisis. The board should conduct a liquidity and credit facilities assessment and "stress test" that includes an evaluation of how the company can best maximize and preserve its liquidity and access to capital. Such an evaluation should include an examination of the company's leverage ratios, access to credit, potential liquidity sources (including working capital), and the potential re-prioritizing of capital expenditures. It also should include a reconsideration of the company's investment policy to minimize investment in high-risk securities. Because banks have been taking advantage of even the least-consequential loan covenant defaults to reset entire debt facilities on more onerous terms, the board should conduct credit facility and covenant default analyses to determine the company's risk of covenant default. Finally, the board should revisit its dividend policies and stock repurchase programs to determine whether these are the best uses of precious cash despite abnormally low stock prices.

Evaluate Executive Compensation Policies

In the current environment, scrutiny of executive compensation is and will continue to be much more intense than in the past. The Troubled Assets Relief Program (TARP) as well as subsequent legislation mandates that a financial institution receiving TARP funds consider whether the company's executive compensation policies encourage "unnecessary and excessive risk that could threaten the value of the company." The compensation committee of a company receiving TARP funds is responsible for making that determination and must certify that it has considered executive compensation in light of the TARP standard and has determined that the standard has been met. It is widely assumed that at least some of the TARP executive compensation standards and requirements will be extended to all public companies in the near future. Accordingly, the board of every public company should examine whether the company's compensation policies discourage excessive risk-taking and further long-term shareholder value creation, including the following considerations:

- Bonuses and equity compensation should be tied to the creation of long-term shareholder value and should be driven by multiple performance goals. Performance-based equity awards are increasingly common and are favored by RiskMetrics Group (formerly ISS) and institutional shareholders. The company should address in its compensation discussion and analysis (CD&A) how incentive- and equity-based compensation is tied to company financial performance goals and how easy or difficult it is for an executive to meet those goals. The board should look at the extent to which discretion is inherent in the company's bonus plans or, if the bonus plan is formula-driven, whether the formula can be manipulated. The board also should consider establishing some bonus goals that are tied to corporate integrity and enterprise risk management.
- The board should evaluate what percentage of executive compensation consists of equity compensation. Increasingly, shareholders and analysts believe equity awards should be a smaller percentage of total compensation than they have been in the past. Restricted stock is now more favored as an equity award than stock options, and many companies are instituting hold-til/through retirement requirements to encourage long-term shareholder value creation.
- Companies should be cautious with respect to the repricing of underwater stock options and stock appreciation rights. Compensation committees are under pressure to reprice these awards to help retain and motivate employees. However, repricing is likely to result in RiskMetrics Group recommending a "Withhold" or "Against" vote with respect to the members of the compensation committee at the next director election.
- The board should look closely at the multiple of the compensation of the company's CEO to the compensation of the company's average worker. If the multiple is very large at the same time that the company's stock price is declining and employees are being laid off, then the company will likely face a public backlash. In addition, any large discrepancy between the compensation of the CEO and that of the other senior executives is a key area of inquiry for the U.S. Securities and Exchange Commission (SEC), and the company must be able to provide support and rationale for the difference.
- To avoid the appearance of a conflict of interest, the board should ensure that any compensation consultant used by the company is independent and hired by the compensation committee. The company also should disclose any other services provided by the consultant.

Improve Shareholder Communications
Companies can improve shareholder relations through increased transparency and responsiveness to shareholder initiatives, proposals, and criticisms. The board should resist a "bunker mentality" and instead expand its dialogue with shareholders and enlist the disclosure committee to help provide transparency to shareholders. In addition, the board could consider instituting investor road shows, Web simulcasts of investor conferences, shareholder "councils," and/or even shareholder blogs. Finally, the board should consider enhancing the company's management discussion and analysis (MD&A) in its next periodic filing to address more sufficiently ongoing and developing trends, risks, and access to liquidity.

Prepare for ''Hot Button'' Corporate Governance Issues
The board should be prepared to consider and address corporate governance issues that have received increased attention in recent years, including (1) majority voting, some form of which has been adopted by a majority of S&P 500 companies; (2) "say-on-pay," which will likely become law in 2009; (3) staggered boards, an issue that shareholders are coupling with majority voting and say-on-pay efforts; (4) separation of the positions of chairman and CEO, depending on the board's composition and the tenure and experience of the CEO; and (5) "poison pills," which have received considerable shareholder attention in recent years and have seen a significant increase during the past six months as companies address their increased takeover vulnerability due to historically low stock prices.

In light of the tremendous challenges confronting companies as a result of the current economic crisis, boards must be more cognizant than ever of the particular risks faced by their companies and by their industries. How companies fare in the face of these challenges will depend in part on whether boards can effectively evaluate their current governance practices and, where necessary, make adjustments to address the current economic environment.

For More Information

For more information on this session or Foley's National Directors Institute — 2009 Web Conference Series, visit Foley.com/ndi or contact Steven R. Barth, Foley moderator of this session.

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