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Governance Committee Roundtable

2008 NATIONAL DIRECTORS INSTITUTE

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GOVERNANCE COMMITTEE ROUNDTABLE

INTRODUCTION

Foley & Lardner LLP presented the “Governance Committee Roundtable” as part of the seventh annual National Directors Institute, hosted by Foley on March 6, 2008, in Chicago. The roundtable was moderated by Foley Partner Yvette VanRiper, Foley Senior Counsel Jessica Lochmann Allen and Douglas Ausnehmer of Deloitte & Touche LLP. Thought leaders were Warren Batts of Methode Electronics, Inc., Bronson Haase of The Marcus Corporation, David Lambert of TD AMERITRADE, Howard Malovany of Wm. Wrigley Jr. Company and Cheryl Mayberry McKissack of Nia Enterprises, LLC.

It is no surprise that practices addressing key corporate governance issues vary on a company-by-company basis, depending a great deal on the size of the company, the demographics of the shareholder base, the composition of the board of directors and management and the business and industry climate facing a company. Notwithstanding these variances, the roundtable participants reached consensus on fundamental matters relating to certain key governance issues.

BOARD AND CEO EVALUATIONS

A comprehensive director evaluation process typically consists of surveys of and/or interviews with a company’s directors and concludes with a report to the full board of the evaluation results by either the chairperson of the board or an identified board committee. Surveys allow for the solicitation of information about a broad range of corporate matters and performance measures measured on a scale that is consistent year over year. Interviews provide a director the opportunity to discuss in greater depth those issues relating to the board and to the company’s performance; ideally, they also draw out issues or concerns that may not surface through a simple check-the-box exercise. Preferably, board evaluations will be conducted by both the full board and representatives of the company’s senior management team so that the process incorporates the potentially different perspectives of those groups.

CEOs are being scrutinized as never before, and boards have become much more active in the CEO evaluation process, generally by instituting annual reviews of CEO performance. The substantive focus of director and CEO evaluations can differ. While board and committee evaluations often focus on the overall functioning of the board as a governing body, CEO evaluations are, by definition, focused on the personal achievements and accomplishments of the individual. CEO evaluations often are more metrics-driven than are their director counterparts, involving a review of the CEO’s specific goals and objectives for the fiscal year — generally as defined by the board at an earlier date — and an assessment of whether those goals and objectives were met. Some boards may also ask CEOs to perform self-evaluations. An effective CEO evaluation process should allow the board and the CEO to establish clear expectations with

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respect to leadership and other corporate goals as well as the metrics used to measure achievement of those goals. This can help an organization develop a clearer focus on its overall strategic objectives. By instituting clearly defined needs and objectives, the process can result in an extension of the board's oversight role to include forward-looking performance.

BOARD AND COMMITTEE COMPOSITION, DIRECTOR RECRUITMENT AND DIRECTOR SERVICE LIMITATIONS

Recruiting and maintaining a strong board of directors is key to the success of any organization. Corporate governance reform has brought with it a focus on the effectiveness of the board and increased responsibilities from a regulatory perspective as well as an emphasis on recruiting the best possible candidates for a company's particular size, industry, geography and operational and strategic goals. There also is an increased focus on director liability, which in turn has forced prospective director candidates to weigh more carefully the risks and rewards, as well as the time commitment, of sitting on a corporate board. The end result is that there are fewer interested director candidates at a time when demand for qualified candidates is increasing, which has forced companies and their nominating committees to become more creative and resourceful in their pursuit of the ideal directors.

Boards are generally giving careful consideration to the skill sets and experience that they need to become stronger and more efficient, oftentimes as a result of information that is elicited during the board evaluation process discussed above. Specifically, boards are carefully considering how to improve or maintain race, gender, geographic and skill diversity among their directors. Varied academic and professional experience and/or diverse backgrounds can assist significantly with comprehensive and creative strategic planning and problem solving. The importance and value of using targeted searches for directors, typically conducted by search firms but assisted by the nominating committee, cannot be overstated. Many specialized search firms exist that can take the lead in helping boards locate candidates who are diverse from an ethnic, gender and geographic standpoint as well as those who have specific skill sets. A board's evaluation process can be integral to ascertaining a board's composition needs in addition to identifying issues concerning board member independence, potential retirement dates and board members who may want to step down.

Committee composition is also an important consideration for a board. It is essential that directors do not feel overburdened by time commitments, particularly those required by service on too many of a board's committees. To assess the effectiveness of its committees, a board should survey directors annually regarding whether they believe their respective committees are performing well, what skills gaps exist and whether each director thinks his or her skills and experience are appropriate for the committee(s) on which he or she serves. In general, a committee should have at least three members whose skill sets clearly will assist the committee in carrying out its designated responsibilities. A board should consider rotating the membership of its committees on a regular basis so that each committee's viewpoints remain fresh.

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Finally, board service limitations are an important consideration because they assist boards in transitioning directors without forcing directors to ask their peers to resign. Many companies have instituted written policies that deal with retirement age and/or term limits. For most companies, however, some flexibility in term limits or age limitations is both necessary and desirable. For example, the board may wish to make an exception to the mandatory retirement age if a director has a specific skill set that the board would have difficulty replacing.

SEPARATION OF CEO/CHAIRPERSON POSITIONS

In response to demand from shareholders and other practical business considerations, many companies are taking steps to maintain their board's independence from the chief executive by separating the roles of CEO and chairperson of the board. Many corporate governance reformers believe that the positions of the CEO and the chairperson should not be combined, because the dual role concentrates too much power in the hands of a single person. Although there is no empirical evidence to date that demonstrates that a separation of the roles leads to greater company performance, the separation trend still exists and is likely to be a topic of consideration for more and more companies in the future.

A successful separation of the chairperson and CEO roles requires a very clear definition of the roles and an articulated division of responsibilities for the respective positions. A company considering this separation should work, perhaps through its governance committee, with consultants, management and other insiders to establish specific job descriptions for the positions so that the company doesn't split the roles in name only. As just one example, the chairperson may be responsible for innovation, strategy and culture while the CEO may be responsible for general management of the company's overall business operations. As with most corporate governance practices, there is no "one-size-fits-all" method of dividing the responsibilities and a company's history may dictate how best to accomplish the split. For example, a company with a founder who wants to stay involved may include him or her in the chairperson role only, while a company bringing on a new CEO may wish to have the outgoing chairperson/CEO remain in place during a transition period. In each case, the division of responsibilities must be tailored to fit each company's distinct facts and circumstances.

Upon a separation of responsibilities, the board also must consider how best to compensate the persons filling the two positions. Typically, the CEO receives a higher salary than the chairperson receives, while in some instances, such as when the founder of the company is the chairman and still is actively contributing to the strategic direction of the company, the salary differential may be minimal.

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SHAREHOLDER ACTIVISM

Hedge funds, public pension funds and other such entities have increasingly been at the forefront of shareholder activism. Public pension funds and other activist shareholders often seek meetings with the independent board members to communicate their opinions and concerns regarding a company's performance, governance, social and political issues and other matters. It may be advisable for companies to seek assistance when confronting challenges presented by these shareholders. For example, the board should take into account the company's shareholder relations programs and should determine whether management or the board should have greater interaction with shareholders. Companies might also consider involving an outside public relations firm to assist in developing an appropriate message to the public regarding hedge fund or other shareholder activist activity. Hiring an outside firm to assist with communications is important because the company's message may need to be different from that which management is accustomed to delivering. In addition, because the separation of economic and voting interest often allows hedge funds to avoid the U.S. Securities and Exchange Commission (SEC) filings required of five percent shareholders, companies may wish to work with analysts to investigate a hedge fund's trades and to understand its holdings in the company's securities.

Many posit that hedge funds are focused solely on short-term gains for shareholders, as evidenced by demands for increased dividends, equity buybacks, transactions that would reduce high-rated corporate debt to junk status, sale of businesses or divisions, facility closures and reductions in employee head count. Recent research, however, indicates that hedge fund involvement in a company's ownership and governance may not always have negative effects. Contrary to the common perception that hedge funds have exclusively short-term interests in a company, a recent academic study demonstrates that the average holding period for hedge funds is greater than 20 months. In addition, if representatives of a hedge fund succeed in acquiring board seats, the hedge fund often assumes a long-term posture because the trading window is likely to be closed to them for most of the year (as it is to other board members).

Of course, the best protection against shareholder activism is for a board to monitor a company's financial performance and to take action as appropriate to prevent underperformance.

THIRD PARTIES IN THE BOARDROOM

Increasingly, companies are inviting third parties, such as accounting and legal experts and consultants, into boardrooms to assist the board with its decision-making processes. In particular, boards often rely on outside expertise to help them satisfy their fiduciary duty of care. Delaware courts have indicated that, while the business judgment rule remains alive and well, boards must demonstrate that they have an adequate deliberative process to satisfy their fiduciary duty. Thus, boards often involve outside experts such as compensation consultants for executive compensation decisions or investment bankers for second fairness opinions. A board often finds outside consultants and experts to be helpful when the board requires the input of

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people who have no relationship to the company and, thus, no interest in the outcome of a particular decision.

It is important, however, for a board not to become so preoccupied with obtaining opinions and reports from experts that it loses focus on effectively evaluating the company's business and performance and on developing the strategic direction for the company.

FOR MORE INFORMATION

For more information on this session or the seventh annual National Directors Institute, visit Foley.com/ndi or contact the moderators and thought leaders directly.

Jessica Lochmann Allen
Foley & Lardner LLP
jlochmann@foley.com

Warren Batts
Methode Electronics, Inc.
WLBATTS@aol.com

John Gimpert
Deloitte & Touche LLP
jgimpert@deloitte.com

Bronson Haase
The Marcus Corporation
bjhaase@mac.com

David Lambert
TD AMERITRADE
david.lambert@tdameritrade.com

Howard Malovany
Wm. Wrigley Jr. Company
Howard.Malovany@wrigley.com

Cheryl Mayberry McKissack
Nia Enterprises
cmayberry@niaenterprises.com

Yvette VanRiper
Foley & Lardner LLP
yvanriper@foley.com

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