

## Corporate Governance Perspective: Current Bearings, Future Directions

# The Sights

### Introduction

Due largely to last summer's enactment of the Dodd-Frank Act, we have entered a watershed period of corporate governance reform. Processes already underway have transformed the relations between corporate boards and corporate shareholders. Even further changes lie ahead. In this article, we take a look at where we are now, what lies ahead, and what it all means.

### Changes Already Underway

Though many of the rulemakings required by the Dodd Frank Act have fallen behind schedule, a number of the implementing rules are already in place and driving changes. In addition, other processes not directly connected to Dodd-Frank are also underway and changing board practices. Four specific governance reform processes are discussed below:

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**1. Say on Pay:** Under Section 951 of the Dodd Frank Act, all but the smallest public companies have had to present their executive compensation plan for an advisory shareholder vote during the current proxy season.

In ways that have surprised some observers, it appears that – even though the shareholder “say on pay” vote is purely advisory – the implementation of the requirement for a “say on pay” vote is having a significant impact on executive compensation practices. As reflected in a May 2, 2011 *Wall Street Journal* article entitled “Firms Feel ‘Say on Pay’ Effect,” many companies, scrambling to win shareholder approval in the say on pay vote, have been pressured to alter pay practices. The article says, “despite some early skepticism, the prospect of such votes has sparked boardroom debate over executive-pay practices that were long rubber-stamped”.

The net effect of this process, and of boards' desire to avoid a negative vote, is that certain compensation practices may fall by the wayside, and all companies will face greater pressure to better align executive compensation and company performance.

At a few companies, shareholders have voted against their companies' pay practices. In at least some instances, litigation has followed the negative vote. These lawsuits are being filed in the form of shareholder derivative suits against the board of directors, the members of the board compensation committee, and in some instances even the company's compensation consultants. What seems clear is that activist investors have targeted executive compensation, and the advisory “say on pay” vote is helping to fuel the fire and even contributing to shareholder litigation.

**2. Proxy Access:** On August 25, 2010, the SEC adopted rules requiring all but the smallest public companies to include in the proxy materials board candidates nominated by shareholders who meet certain qualifying criteria. In order to nominate a candidate, a shareholder or shareholder group must individually or collectively own at least three percent of the voting power of the company's shares and must have held those shares for at least three years.

However, on September 29, 2010, the Business Roundtable and the U.S. Chamber of Commerce filed a lawsuit challenging the proxy access rules. The petitioners contend that the new rules are

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“arbitrary and capricious”, violate the Administrative Procedures Act, and infringe on the First and Fifth Amendments. In response, the SEC, on October 4, 2010, issued a stay of the effectiveness of the rules while the legal challenge is pending. A ruling in the legal challenge is expected later this year.

While the implementation of the proxy access rules are in abeyance and the outcome of the legal challenge is uncertain, the likelihood is that shareholders will enjoy greater access by requiring a company to include in its proxy materials shareholder nominees to the board of directors. According to an October 29, 2010 legal memo from the Saul Ewing law firm, “whether under the rules now being considered by the court or some revision thereof, the Dodd-Frank Act, and its focus on shareholder protection and access, ensures shareholder activism is here to stay.”

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**3. Board Declassification:** One of the long-standing objectives of corporate governance reformers has been the elimination of classified or staggered boards, whereby directors are elected for three year terms ensuring that in any given year only a third of the directors are up for vote. The Dodd-Frank Act does not have anything to say directly on this issue. Nevertheless, reformers led by the Florida State Board of Administration have succeeded in obtaining the voluntary agreement of a number of companies to the declassification of their boards, pursuant to which the companies will put their entire board to an annual vote. As one recent commentator noted, “the overwhelming trend in corporate governance is toward the declassification of boards.”

**4. Majority Voting:** Another longstanding goal of corporate governance reformers has been the implementation of majority voting. In many U.S. public companies, director election requires only a plurality vote, so that a director candidate in an uncontested election who receives only one vote will be elected. In a majority vote model, a director in an uncontested election who fails to receive a majority of votes must offer their resignation.

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As discussed in an April 19, 2011 Westlaw Business article entitled “Corporate Governance: Assertive Activist Investors,” the 2011 proxy season is the “culmination of a major drive to install majority voting standards,” and shareholders at a number of companies have voted in favor of shareholder proposals calling for majority voting standards.

## Changes Just Ahead

**1. Compensation Ratios:** Section 953(b) of the Dodd Frank Act directs the SEC to amend its executive compensation disclosure provisions to require reporting companies to disclose the ratio between total annual compensation of their CEO and the median annual compensation of their employees. Rules implementing these provisions are required to be adopted before the end of 2011.

As University of Denver Law Professor Jay Brown has commented, these disclosure requirements could potentially be “powerful.” As Professor Brown notes, the compensation ratio disclosure would shift the executive compensation dialog away from a comparison between executive compensation at different companies toward a comparison within the company itself. The provision apparently reflects a sense that there is a disparity between the compensation paid to executives and the compensation to other company employees.

These provisions are controversial and there is already a move underway to repeal them. But if the provisions become effective and reporting companies are required to disclose the compensation ratio as specified in the Dodd-Frank Act, it seems likely that what will follow is a protracted discussion of compensation fairness and compensation equity, particularly as popular notions about the appropriate compensation ratios develop over time. Companies whose ratios suggest greater compensation disparity are likely to face added pressure on executive compensation issues.

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**2. Compensation Clawbacks:** Another of Dodd-Frank's executive compensation requirement is set out in Section 954, which requires the SEC to direct the national exchanges to impose new listing standards directing public companies to implement compensation clawback provisions. Under Section 954, companies making accounting restatements of prior financials must recover from any current or former officer all incentive-based compensation paid during the preceding three-year period above what would have been paid without the misstated financials. According to a May 12, 2011 *CFO.com* article about the provisions, the SEC plans to propose and adopt rules implementing these requirements between August of this year and year-end.

The Dodd-Frank clawback provisions go far beyond the clawback requirements instituted in the Sarbanes Oxley Act. The SOX provisions were limited just to the CEO and CFO, whereas the Dodd-Frank provisions are applicable to current and former executive officers. SOX clawed back only the year prior to the restatement, whereas the Dodd Frank provisions reach back three years, and are applicable without regard to fault or wrongdoing.

The clawback provisions have also proven controversial. The *CFO.com* article notes that these provisions have a "potentially far-reaching impact" that may "result in serious reconsideration of how incentive compensation plans are designed." It is also possible that companies who find that they must restate prior financial, may face litigation (or rather their officers and directors may face litigation) on questions of whether a compensation clawback is required, against whom it should be enforced, and for what types or amounts of incentive compensation.

### What It All Means

Though rule-making delays and litigation have stalled the implementation of some of the Dodd-Frank Act's requirements, many of the changes Dodd-Frank required are already here, and others are just around the corner. These changes and the other corporate governance reforms being pursued by shareholder advocates have a number of significant implications, beyond just the most obvious practical effects.

**1. Heightened Scrutiny:** Not all companies are going to give in on executive compensation issues or on board process issues like board declassification and majority voting. Indeed, there are certainly a number of serious commentators who question the value or even the wisdom of many of these reforms. But while different companies may respond to these developments in varying ways, companies that resist these governance developments may face heightened levels of scrutiny, both from shareholders and from the media.

**2. Increased Litigation Risk:** Companies that resist shareholder driven reform initiatives may not only face scrutiny, but they (or their directors and officers) may also face an increased likelihood of litigation. As noted above, companies that experience a negative “say on pay” vote may find themselves facing shareholder litigation related to the companies’ compensation practices. As noted above, there are other initiatives among these current reforms – for example, the clawback provisions – that could also encourage shareholder litigation.

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**3. Changing Judicial Attitudes:** A very strong principle traditionally informing judicial scrutiny of board processes and decision-making has been a broad deference to the boards themselves. With the shift towards greater shareholder empowerment, courts may be less inclined than perhaps they were in the past to defer to boards.

This notion that evolving corporate governance norms may affect judicial consideration of board process and functioning was highlighted in Chancellor Chandler’s August 9, 2005 opinion in the Walt Disney Shareholder Litigation, where Chandler observed that “in this era of Enron and WorldCom debacles, and the resulting legislative focus on corporate governance, it is perhaps worth pointing out that the actions (and the failures to act) of the Disney board that gave rise to this lawsuit took place ten years ago, and that applying 21st century notions of best practices in analyzing whether those decisions were actionable would be misplaced.”

The Chancellor’s unmistakable implication is that heightened 21st century standards *will be* applied to 21st century board actions - in other words, as corporate governance standards change, boards will be held to standards of conduct reflecting the changed governance norms and expectations. And in an era of growing shareholder empowerment, that reality may translate into increased judicial expectation for boards to address shareholder initiatives and concerns.

## Conclusion

There is room for serious debate about whether or not these changes will ultimately advance or impede corporate performance and what impact all of this will have on the relative competitiveness of U.S. companies in a global marketplace. But whatever may be said, it seems clear that the changes brought about in the current round of corporate governance reforms are here to stay and will require corporate officials to adapt to the new environment. The changes may also mean new areas of litigation exposure for corporate officials.

### About the Author

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