FIVE CRITICAL ISSUES FACING DIRECTORS OF PUBLIC COMPANIES TODAY

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If you want an easy job, being a director of a public company is not it!

Many pundits are asking "why would anyone want to serve on a public company board today?" Well, there are many good reasons including providing leadership and vision to maintain the global competitiveness of America's economy and public companies. So, if you want an important job—be a director because by law you are the ultimate authority of the corporation! And, as the wise adage goes, "necessity is the mother of invention." Directors' needs and concerns can be addressed with creative thinking and new solutions.

The threat of securities litigation is lurking behind every significant decision made by a director and board. Even failure to act in certain circumstances creates liability exposure. The responsibility and potential for liability of directors has increased in the face of the well documented corporate financial failures of 2001-2002 [Enron, et.al.] and within the last twelve months with the fall of the giants. What went wrong? Where was the board of directors at each of these failed corporations? Many of the world's best and brightest minds are focusing a considerable amount of time trying to answer these questions. The financial and reputation losses and disruption to our economy have been staggering. Boards of directors are going to continue to be scrutinized, and directors can expect more scrutiny and more intrusive laws and regulations to further complicate things. The job of being a director is too important to leave to amateurs. To continue to attract the best talent into our boardrooms, we must arm our directors with greater resources and direction to accomplish their tasks and goals effectively. In The Recurrent Crisis in Corporate Governance authored in 2003 by Ira Millstein and Paul MacAvoy, corporate governance authorities, the authors state "access to information or even to management is too limited; the board is taking on responsibilities without the means to fulfill its obligations."

In order to give directors the needed resources to perform their jobs, we need to understand their concerns. This article discusses five critical issues directors need to consider for the foreseeable future and to develop procedures and practices to address the NACD Principles (as described below).

I. **Improved Corporate Governance**

Some believe that we have a crisis in corporate governance of recent origin, but in reality this "new crisis" has been more than thirty years in the making. The argument is that unless directors self-regulate and adopt reforms to their corporate governance systems, new laws and regulations will dictate to directors what they can and cannot do; i.e. more government in our lives. So, what can and should directors do? The first thing they should do is to have their board, through the leadership of their governance committee, study, debate and discuss the National Association of Corporate Directors (the "NACD") Key Agreed Principles (the "NACD Principles"), which the NACD published in late 2008 and are supported by the Business Roundtable, an association of CEO's of leading U.S. companies with over $4.5 trillion in annual revenues and nearly 10 million employees and which is recognized as a leading voice on corporate governance issues. Studying and discussing these principles are critical because deficiencies in corporate governance systems were at least partly responsible for the recent financial collapse of our economy, and we need to restore public confidence and trust in our corporations and financial institutions. The NACD, the largest leading national association serving corporate directors, has provided a road map to get Boards "back on track." The study and implementation of the NACD Principles should be a no-brainer for public companies! There is no one right answer or approach to the issue of corporate governance. One size does not fit all when it comes to the practice of corporate governance in public and private companies. Every public company board, however, needs to embrace these NACD Principles and apply them thoughtfully to their own companies. The NACD Principles are grounded in the common interest of shareholders, boards and management teams in the corporate objective of long-term value creation. The NACD Principles provide a framework for board leadership and oversight in the especially critical areas of strategic planning, risk oversight, executive compensation and transparency. But, at the end of the day, directors, individually, and boards, collectively, must act thoughtfully—not just give lip service to the issue or apply the NACD Principles in cookie cutter fashion. Boards should search for the governance best practices, thoughtfully and uniquely adapt them to their companies and follow them in form and substance. Then they should explain in their company's proxy materials and other communications with shareholders how the procedures and policies they have adopted are in the spirit of transparency and why the governance structures and practices which they developed are best suited to their company and the maximization of long-term shareholder values.

Why not get creative?

The idea has been raised of corporations preparing and distributing to shareholders a Governance Discussion and Analysis [“GD&A”]— (a similar approach to the presently required Compensation Discussion & Analysis [“CD&A”]) in proxy statements or annual reports. Why not? Perhaps if a few corporations voluntarily prepared and publicly disclosed a GD&A, this approach to transparency in corporate governance would gain momentum and many would follow thereby going a long way toward winning back public trust and confidence. It will take great leadership from our boards to do this, but it needs to happen.

Boards need to initiate actions – be proactive; there is an opportunity to lead. In sum, the concern is a big one, but the answer is obvious and not that difficult!

2. **Section 11 of the Securities Act of 1933**

If a registration statement contains a material misstatement or omission, §11 of the Securities Act of 1933 provides that an outside director is liable to those who purchased securities unless the director succeeds in providing a due diligence defense. To succeed in this defense, a director must prove (1) that he engaged in reasonable investigation; (2) that with respect to those portions of the registration statement based on the authority of an expert, the director had no reasonable ground to believe, and he did not, in fact, believe that any information was materially misleading or false; and (3) that with respect to other portions of the registration statement, he had reasonable grounds for believing that the registration statement was accurate and did not omit to state material information. Most domestic courts typically judge directors’ compliance with the “reasonable investigation” and “reasonable grounds” requirements under a negligence standard.

In an article entitled “Outside Director Liability” published in the Stanford Law Review in February, 2006, the authors state that “all securities settlements [since 1980] that we found in which directors paid out-of-pocket damages were brought under §11.”

What does this tell us? First, a director faces the highest legal standard—negligence—under §11—a higher standard than in any other area of corporate law for directors. That is a big red flag, so in connection with securities offerings, directors should and need to ask meaningful questions and demand responses. In other words, pay attention and stay involved throughout the offering process and pay particular attention to the disclosures made in prospectuses and otherwise throughout the entire offering process. Public companies should also adopt procedures for officers and directors that

will help with a due diligence defense in the event a securities lawsuit gets filed alleging material misstatements or omissions in a registration statement under §11.

3. **Climate Change**

If you are wondering how big of an issue climate change is, consider the fact that as of May 2009, more than 235 bills, resolutions and amendments have been introduced into Congress to regulate factors contributing to climate change. At the state level, more than 14 states have passed mandatory targets for the reduction in greenhouse gases.

As Carol A. N. Zacharias points out in her recent article entitled, “Climate Change is Heating Up D&O Liability”, new climate change litigation goes beyond pollution litigation. The new cases address the adequacy of a company’s assessment of the financial consequences of climate changes and the adequacy of disclosures and shareholders of that financial impact.

Companies must evaluate whether, when and to what extent climate change regulations present material risks, warranting disclosure by public companies under Items 101 and 303 of Regulation S-K of the U.S. Securities Laws. With increased disclosure comes the risk of increased liability—(1) directors can be held liable under Section 10(b) of the Securities and Exchange Act of 1934 for omissions or material misrepresentations and (2) directors can be held liable under the Securities Act of 1933 [Sections 11 and 12] for factual omissions or material misrepresentations in public offerings. One study estimated that 53% of the largest public companies are doing a poor job of disclosing climate related risk, putting the company’s “at risk of shareholder lawsuits” [“Limiting Liability in the Greenhouse Insurance Risk Management Strategies in the Context of Global Climate Change” – Stanford Environmental Law Journal – May 30, 2007]. Directors need to address this issue—it is not going away.

4. **Insolvency of Corporation**

If an outside director is sued and found liable under the securities laws, indemnification by the company potentially provides protection against out-of-pocket liability for the directors. The possibility of the Company’s insolvency presents special financial risks to the director because indemnification payments will be unlikely or even if made, forfeitable if the company was insolvent.

Almost all public companies have indemnification agreements with outside directors or by-laws that convert this permission into an obligation to directors by providing that the corporation shall advance legal expenses and indemnify legal fees, damages, and amounts paid in settlement to the fullest extent provided by law. Without indemnification by the company due to insolvency, directors are left

having to pay expensive legal bills and possible judgments. Could this happen to you as a director? The unfortunate, but realistic answer is yes!

In today's world with banks still being greatly restricted in their lending ability and in renewing credit agreements and waiving covenant defaults, many corporations are at greater risk of an insolvency, which formerly would not have been the case. Euler Hermes International Insolvencies Outlook, worldwide leader in credit insurance, is forecasting a 35% increase in corporate worldwide insolvencies for 2009 [45% for USA] after a 27% increase in 2008 [54% for USA]. "In the current recessionary environment, we will witness a sharp worsening of the insolvency trend everywhere in the world, at least up to the end of 2009. We expect our Global Insolvency Index to rise by 35%. As for next year, it is unlikely that the level of business insolvencies will abate: they may stop rising in some countries, but the very light winds of recovery we anticipate will not save many more businesses in 2010 than they will in 2009." Insolvency creates the worst possible scenario for directors.

5. **<u>What's Around the Corner [That I Cannot See]</u>**

Every director should be concerned about what's around the corner that he cannot see. "More information" should be his mantra—from management and outside experts. And still, there will be the issue that no one saw coming. What can the director do to protect himself? It is called directors' and officers' liability insurance, commonly called "D&O Insurance".

It is not enough for a director to ask "do I have D&O insurance?" Virtually all public companies purchase D&O insurance for their directors and officers. D&O insurance covers directors' legal expenses, damages paid pursuant to judgment and amounts paid in settlement. Neither corporate law nor securities law places limitations on the permissible scope of D&O coverage.

So, what are the D&O issues that directors should be concerned about?

First, damages awarded in a lawsuit may exceed the amount of insurance available under a policy. The policy limit may have been insufficient from the start or the policy may have been exhausted by litigation expenses incurred by insider managers and directors of the company. An example of this situation is the <u>Just for Feet</u> case where directors had to pay personally over $40 million in the settlement of that case…the largest out-of-pocket payment by outside directors following corporate-fraud allegations. Second, if the company becomes insolvent, outside directors could be vulnerable because the D&O policy could become the property of the bankrupt estate. Finally, there is a flaw in the way D&O is purchased from the directors' perspective.

Generally speaking, when D&O coverage is procured by the company, it is accomplished by the CFO, general counsel or risk manager of the company without anyone in the process representing the outside directors. This creates potential conflicts. For example, how large should the limits be for outside directors? For the company? What is the budget for D&O? Should it be more? Who decides? Is a "state-of-the-art" policy being purchased which will include Side A coverage which will prevent exhaustion or depletion of the policy for the outside directors? Are all the coverage "gaps" which could arise and hurt the outside directors addressed? Does the policy cover the unknown? The bottom-line is that a director needs a "state-of-the-art" policy and a voice in the D&O policy procurement process.

Warren Buffet memorably said "You only find out who is swimming naked when the tide goes out." This applies quite nicely to the job of being a director. There are a number of things that are very difficult to know about until after the fact.

In the litigious world we are living in today, directors' needs should be addressed creatively and on a timely basis to help create an environment which enables them to do their critically important jobs of leading this country's corporations.