AGENDA

THE WEEK'S NEWS FROM OTHER BOARDROOMS

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Safety Issues to Snare More Execs in 2016

Legal cases and regulations raise risk of safety violations

by Melissa J. Anderson

The conviction of **Don Blankenship**, former CEO of Massey Energy, this month on mine-safety charges shows federal prosecutors are keener to pursue top executives for safety issues, legal experts say.

Blankenship presided over the company during the Upper Big Branch mine explosion that killed 29 workers in April 2010, the worst mining disaster in the U.S. in 40 years.

Following the outcome of this case and other recent legal and regulatory moves to bring harsher penalties against executives and companies that break safety laws, boards should review corporate safety policies and key metrics, say experts. And if their CEO or another top executive does come under fire, boards should be prepared to implement a special committee or an outside investigation to show regulators and shareholders they are dedicating the proper care to the situation, experts say.

The Blankenship case and other recent cases that have targeted executives also reflect the **Department of Justice**'s new focus on prosecuting

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Everyone's a Target: Activism's Mega Year

The Dow-DuPont tie-up caps a significant 2015 for activists

by Marc Hogan

Shareholder activists took aim at their largest targets yet in 2015, a story line that reached a fittingly blockbuster-size climax this month when **Dow Chemical** and **DuPont**, both subject to activist pressure, declared a $130 billion mega-merger.

One of the biggest deals in the history of business, the pact added an exclamation point at the end of a year when activism accelerated beyond its already bustling 2014 levels. It was a year of similar activist successes. At the same time, activism defense advisors say, 2015 was marked by boards' becoming more engaged with the sentiment of shareholders overall, including traditional, long-only institutional investors.

There is no letup in sight for shareholder activism, which will continue to affect companies of all sizes in 2016, these board advisors say. If the past year brought heightened director awareness of the activists at their gates,

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Happy Holidays!

Agenda will not publish next week because of the holidays. Our next print issue will come out on Jan. 4.

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Mondelez CEO Juggles Calls From Two Activists

Mondelez International CEO **Irene Rosenfeld** frequently gets an earful from **Nelson Peltz** and **William Ackman**, as *The Wall Street Journal* reports.

Rosenfeld said handling the concerns of the company's two major activist shareholders devours one quarter of her time. Peltz reportedly called her after Halloween with advice about children's eating preferences based on the behavior of his 12-year-old twins. Ackman has been pushing her to shrink her product lineup and plot a new course on advertising.

"I'm frustrated with investors' fascination with activists," Rosenfeld told the *Journal*. "I'm successfully running Mondelez for all shareholders — without the activists' help."

Mondelez lead director **Mark Ketchum** said Rosenfeld is like any CEO in being less than thrilled at having an activist shareholder. "How can she not take it personally?" he asks.

Rosenfeld advises getting activists "inside the tent" rather than fighting proxy contests. But she reportedly bristles at the pressure for short-term results, saying the activists' wish lists, piled atop macro challenges, can "add insult to injury."

Mondelez gave Peltz a board seat last year, avoiding a potential proxy fight. Ackman disclosed a Mondelez stake this summer and indicated the company could be sold.

Mondelez chief growth officer **Mark Clouse** told the *Journal*, "Irene is driving this train, but she has strong pressures trying to control where to go and how fast."

Wendy's, where Peltz is chairman, has become a family affair. The fast-food chain said on December 15 it had named the billionaire's son, **Matthew Peltz**, to the board. The younger Peltz fills a spot vacated by **Ed Garden**, who resigned to pursue other commitments.

Wendy's also added **Legg Mason** director **Dennis Kass** to its board, which expanded from 10 to 11 members.

Valeant Audit Chair Held Same Role at Fraud-Hit Firm

Valeant Pharmaceuticals audit committee chair **Norma Provencio** previously led the audit committee of a publicly traded company that collapsed amid fraud allegations, Bloomberg reports.

Provencio is one of four Valeant board members on a recently formed ad hoc committee to investigate the company's close ties to mail-order pharmacy **Philidor**. On December 16, Valeant slashed its financial forecasts, citing the end of that relationship, which has drawn attention from Congress.

From mid-2005 to mid-2007, Provencio — who isn't accused of wrongdoing — chaired the audit committee of a company called Signalife, later known as Heart Tronics. **Mitchell Stein**, a lawyer who reportedly brought her to the company, was eventually sentenced to 17 years in prison for his role in a fraud scheme at the company beginning in 2005. Stein also paid more than $11 million in **SEC** civil penalties. The business went under in 2012.

Nell Minow, vice chair of **ValueEdge Advisors**, told Bloomberg that Provencio's prior role muddled the message of probity that an ad hoc committee is meant to send. Valeant director **Theo Melas-Kyriazi** and others who've worked with Provencio said the optics of the Signalife case don't match the honest, highly qualified director they know.

Audit committees in general may be having a hard time recruiting the appropriate members, partly due to the role's mounting workload, reports *The Wall Street Journal*. SEC chair **Mary Jo White** noted the added complexity in a recent speech, saying, "I have growing concerns about the amount of work required of some audit committees." **Robert Swieringa**, professor emeritus of accounting at **Cornell University**'s Johnson Graduate School of Management, said finding audit committee candidates is "becoming increasingly difficult." ■

— Marc Hogan

Avoid Director-Pay Lawsuits With Longer Holding Periods

Post-vest holding periods improve shareholder-director alignment

by Laura Wanlass and Terry Adamson

Laura Wanlass is an associate partner in the executive compensation and corporate governance practice at **Aon Hewitt**. **Terry Adamson** is national practice leader for Aon Hewitt's employee equity consulting practice.

Boards should require directors to have longer holding periods for equity compensation in order to align themselves better with shareholders and avoid lawsuits.

Many consider the increase in litigation for perceived self-dealing and unjust enrichment in non-employee director equity compensation a nuisance. But the inherent perceived conflicts of interests regarding how director compensation is ultimately determined and approved makes it an easy target for plaintiff's law firms. Specifically, the same group of individuals not only sets their own targeted compensation levels but also approves it. Unlike executive compensation, which is set and approved by independent and disinterested members of a compensation committee, there is no disinterested group of individuals doing the same for director compensation.

To combat this increase in litigation, most companies are engaging in some combination of these three actions: actively considering hard-coding annual equity compensation limits in the shareholder approved plan documents; adopting stand-alone non-employee director equity compensation plans; and increasing disclosure around the annual non-employee director compensation-setting process in the annual proxy statement. Further, best practice is to adopt vigorous mandatory holding periods after vesting. Holding periods can mitigate perceived conflicts of interest and strengthen the alignment between non-employee directors and shareholders. They are also viewed favorably by proxy advisory firms and their investor subscribers.

While the cash portion of a non-employee director's annual retainer could be viewed as payment for the day-to-day tasks of fulfilling their fiduciary duties, holding the equity compensation component of pay — perhaps even until retirement, as some companies have done — provides greater incentive for directors to focus on long-term growth. In addition to providing better director-shareholder alignment, mandatory holding periods give companies the ability to reduce their reportable equity compensation expense with an illiquidity discount, since inherently illiquid shares are less valuable than freely tradable shares. Generally, the longer the holding period and more volatile the stock is, the greater the discount would be to compensation expense.

While an increasing number of companies are taking advantage of such reportable accounting discounts due to holding periods for non-employee directors, boards may not want to go as far as to use such discounted valuations in determining the number of shares that should be awarded to non-employee directors. For example, if a company wishes to grant $100,000 of value to a non-employee director when the stock price is $10, that would equal 10,000 shares. The accounting value would equal $85,000, assuming a 15% discount for a three-year mandatory holding period after vesting. Alternatively, if the board compensated for the illiquidity, they would need to grant the director 11,765 shares in order to have the full $100,000 accounting value.

Using discounted valuations in setting actual equity grant sizes for executives is easier to justify than it is for non-employee directors. Equity compensation for executives and non-employee directors can serve similar purposes, as retained shares can help to align management and director interests with shareholders. But in reality, illiquidity of a meaningful portion of vested equity compensation for executives is forcing such executives to defer what is frequently needed as immediate cash flow, as opposed to a director who likely has an alternative source of cash flow. To ensure competitiveness and to obtain buy-in from executives for such holding periods, many companies use the discounted valuation in setting executive award levels. That means the perceived illiquidity risks are offset by a greater number of shares.

Given the many benefits to adding mandatory holding periods to equity compensation grants for non-employee directors, the prevalence of these provisions will likely grow over the next few years. However, the rise of shareholder litigation and other potential negative events associated with using a discounted valuation to set non-employee director grant sizes should give directors pause. Boards may not want to make this practice as prevalent as the holding periods themselves, as this could be potentially viewed as self-dealing, since the director would ultimately end up with more shares. ■

Audit Committees Face Mounting Workloads in 2016

The coming year will see a focus on increased transparency and audit quality

by Lindsay Frost

The **Public Company Accounting Oversight Board** (PCAOB) last week voted to establish a new rule requiring additional disclosures from audit committees under its increased push for boards to be more transparent about their work with external audit firms.

This additional regulatory push for disclosure comes at a time when audit committees are increasingly overloaded with responsibilities. Audit committees will have to consider how to address public disclosures involving work with external auditors, improve audit quality and manage increased oversight responsibilities in the coming year, experts say.

"Audit committees are grappling with new and emerging issues and risks," writes **Cindy Fornelli**, executive director at the **Center for Audit Quality**, in an e-mail. "In 2016, we believe the enhanced disclosure trend will persist and there will be a continuation of robust discussions around the utility of audit quality indicators. All of this is in response to the increasing interest by investors, regulators and other stakeholders in the roles and responsibilities of audit committees."

Agenda identified three areas that audit committees will be focusing on in their 2016 plans:

1) Push for disclosure

The financial crisis and the passage of Sarbanes-Oxley led to pressure on audit committees to be more transparent in their oversight of external auditors.

"Policymakers and other stakeholders have been active in promoting consideration of greater transparency around how audit committees carry out their responsibilities," says **Jennifer Lee**, partner at **EY**'s Center for Board Matters.

The PCAOB's new rule requires companies to name the audit firm representative responsible for the firm's engagement with the company and identify other accounting firms participating in the audit. This is an important step in mitigating audit deficiencies, said **Steven Harris**, PCAOB board member, at the organization's open meeting on the rule last week.

Harris said the rule directs responsibility to the "right people," holding them accountable for faulty audits. The rule will allow the public to see the audit firm representative's track record.

The **SEC** also addressed the transparency of audit committees' work with external audit firms by issuing a concept release in July. The release included revisions to mandatory audit committee disclosures, though the regulator has not proposed a time line for implementation.

"A significant number of responses have been submitted [to the SEC] questioning the need for these additional disclosure requirements," says **David Walker**, chair of the audit committees of **Chico's FAS**, **CoreLogic** and **CommVault Systems**.

Walker says companies are more willing to disclose additional information, but some audit committees question the need for "one-size-fits-all" disclosures about specific items discussed with external audit firms.

According to a **BDO** survey of 150 U.S.-based corporate directors released last month, 87% think that disclosing specific communications between the audit committee and external auditor would negatively affect the relationship between the two.

Audit committees are volunteering more information about their external audit firms in proxies. These disclosures include audit firm tenure, external audit evaluation criteria, audit representative selection and audit firm rotation and appointment.

For example, **Energizer Holdings** outlined its audit partner rotation policy in a December proxy filing, highlighting how often this was discussed in management meetings.

According to the Center for Audit Quality (CAQ) and **Audit Analytics**' 2015 Transparency Barometer, as of June, 24% of S&P 500 proxies disclosed the criteria audit committees considered when evaluating the external audit firm, compared with 8% in 2014.

More than half (54%) of the proxies disclosed the audit firm tenure, compared to 47% in 2014.

American International Group, **Primerica**, **Vertex Pharmaceuticals**, **Full Circle Capital**, **Daktronics**, **Luby's** and **Johnson Controls** all expanded their audit committee reports in proxies this year to include more information about the respective evaluations of external audit firms and other responsibilities of the committee.

"Providing voluntary audit-related disclosures has continued and expanded even further," EY's Lee says. Lee adds that she expects this to continue next year.

The PCAOB writes in the new rule that companies must submit a Form AP naming the audit engagement partner for all public filings submitted on or after January 31, 2017. A Form AP naming other participating audit firms is required for all public filings filed on or after June 30, 2017.

2) Audit quality

Audit committees are also working on improving the quality of the external audit. Companies tend to vary in how they evaluate the quality of the audit, experts say. The PCAOB and CAQ are working on creating standards to assess audit quality.

The PCAOB proposed 28 audit quality indicators in July that cover areas such as availability, competence and focus of audit firm professionals; audit firm leadership, incentives and independence; and audit results within the financial statement, including restatements, internal controls and going concerns.

Audit committees would use these indicators when evaluating their external audit firms' performance. Walker adds that audit committees are trained to investigate and take "immediate action" if any of these quality indicators are questioned.

"We continue to see … the need for better tools to help audit committees and other stakeholders identify factors impacting audit quality," Lee says.

The CAQ released an assessment tool in June that includes 18 sample questions the organization says audit committees should consider in evaluating audit quality.

Neither set of standards is mandatory, but both should be considered best practices, Fornelli writes.

3) Managing responsibilities

Audit committees are also being given more responsibilities, such as overseeing information technology and improving internal controls systems and enterprise risk management, data from the **KPMG** Audit Committee Institute's 2015 global audit committee survey shows.

"Public companies' audit committees have more responsibility for oversight of IT, and considering how quickly technological advancements occur, they have to spend more of their time dedicated to it," says **Paul DeNicola**, managing director of **PwC**'s Center for Board Governance.

Out of 1,500 audit committee members surveyed for the KPMG survey, 75% said the amount of time required to complete their responsibilities has increased either moderately or significantly over the past two years.

Risk management, regulatory compliance and industry concerns, such as commodity pricing, are the top contributors to this, according to the survey. DeNicola says audit committees need to increase communication with management to assess the importance of these responsibilities.

Brooks Automation disclosed in a December 11 proxy filing that this year the audit committee reviewed how its management conducts a risk assessment survey and new risk exposures to the business.

"Audit committees are assessing and working on improving the materials they receive from management to determine how all of the additional regulations and concerns over IT, fraud risk and other risk strategies should be prioritized," DeNicola says.

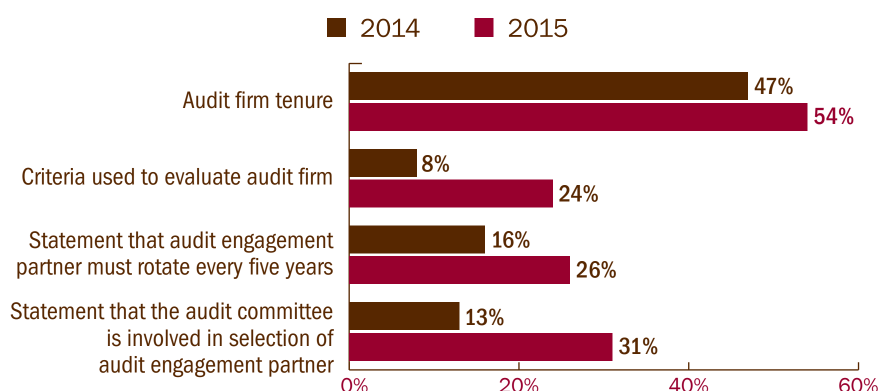
For example, in a December 16 proxy filing, **Meridian Bioscience** disclosed in its auditor report that the audit committee met with management in the summer to discuss the outlook for the rest of 2015 and prioritize its work. In this meeting, the committee consulted an independent cyber-security consultant and reviewed the results of IT controls testing at the company.

Oversight of financial statements, fraud deterrence and accounting changes remain audit committees' top priority despite new obligations, EY's Lee adds.

"Over the next two years, [audit committees] will look to improve financial reporting across a variety of financial communications channels." ■

Audit Committees Increase Transparency

Percentage of S&P 500 companies with disclosure in their proxy



Source: CAQ and Audit Analytics

Lindsay Frost (212-542-1228 or lfrost@AgendaWeek.com) covers shareholder and auditing issues.

Boards Link Skills Matrix to Strategic Plan in Proxies

Investors are increasingly interested in learning more about directors' soft skills

by Amanda Gerut

More boards are publishing skills matrices in proxy statements and a handful have gone further, linking broad objectives in companies' strategic plans to directors' specific attributes.

A study conducted by compensation data firm **Equilar** released last week reveals that 33 S&P 500 companies published skills matrices in 2015 proxies. A recent report from search firm **Spencer Stuart** also suggests that disclosing a skills matrix is increasingly being viewed as best practice, which means more boards are likely to provide them in proxy statements in coming years.

In addition, among the 33 companies that published skills matrices this year, at least half a dozen connected the skills among current board members with certain strategic objectives. Companies such as **Anthem**, **Avery Dennison**, **Coca-Cola**, **General Electric**, **MasterCard** and **Wal-Mart Stores** provided either an additional chart or a narrative explaining to investors how certain areas of expertise help provide oversight of the main pillars of their strategic plans.

For example, Coca-Cola published a skills matrix describing the number of directors on the board with a "high level of financial experience" or "broad international exposure and emerging market experience." The company also links some of the attributes of directors to the business characteristics of Coke. The company uses an infographic noting that marketing and innovation are core focuses of the business. The document says Coke seeks to develop and deploy the "world's most effective marketing and innovative products and technology." Thus, the board prizes marketing, innovation and technology experience among directors' skills.

Seven directors on the board are listed in the skills matrix as having one or both of the skills Coke has identified as most relevant, based on the company's strategic focuses.

Homing In on Director Skills

Matthew Goforth, Equilar's lead research analyst, says progressive companies have been seeking out additional ways to communicate information about board composition to investors in more digestible formats.

In recent years some boards have raised the stakes, publishing the skills matrices that nominating and governance committees rely on internally.

Spencer Stuart's recently published 2015 board index notes that investors are probing companies' disclosures for "a well-explained rationale for why the group of people sitting around the board table are the right ones based on the strategic priorities of the business." It adds, "Publishing a skill matrix and sharing the board's thinking about the types of expertise needed on the board — and how individual directors provide that expertise — are increasingly considered best practice."

Goforth describes the skills matrices as essentially tables with lists of skills with check boxes and marks next to specific directors. For instance, **Best Buy**, **Corning**, **Kimberly Clark**, **Eli Lilly** and **United-Health Group** provided such tables in their 2015 proxy statements.

Among the boards that provide skills matrices, the most commonly cited skills disclosed are financial expertise (62.5%), experience in the company's specific industry (59.4%), international experience (46.9%), a previous or current role as a senior officer (43.8%) and government or regulatory experience (43.8%).

Skills and Strategy

However, taking the further step of assessing the skills of directors in light of a company's strategic plan and disclosing it to investors can raise a host of issues for nominating and governance committees, observers say.

One particularly sticky issue that has arisen is how to deal with situations in which directors view themselves as experts in certain areas when CEOs and management teams disagree.

Andrea Plotnick, national director of organizational effectiveness at **Hay Group**, has occasionally seen clients unearth discrepancies when board evaluations require directors and members of management to rate board members' areas of expertise.

Plotnick says sometimes the issue stems from the fact that the board isn't aware of what directors don't know, while sometimes management isn't aware of the skill sets and expertise of directors sitting on the board.

For instance, Plotnick says she's seen boards rate themselves highly in strategic application of information technology, but what directors think they're rating isn't what management considers to be strategic application of IT.

S&P 500 Boards That Publish Their Skills Matrix

	Amphenol		HCP
✓	Anthem		Kimberly Clark
✓	Avery Dennison		Kraft Foods Group
	Best Buy		Eli Lilly & Co.
	Cameron International		Macy's
	Chesapeake Energy Corp.	✓	MasterCard
	CME Group		McDonald's
✓	Coca-Cola		MetLife
	Comcast		Michael Kors Holdings
	Computer Sciences		Norfolk Southern
	ConocoPhillips		PepsiCo
	Corning		Phillips 66
	Expeditors International of Washington		QEP Resources
	Ford Motor	✓	Wal-Mart Stores
	General Dynamics		Williams Companies
✓	General Electric		Xerox

Source: Equilar

✓ Boards also tie the skills matrix to strategy in their proxy

"What [directors] are thinking could be totally different than what management is thinking," says Plotnick. "There's been a whole paradigm shift."

The rapid evolution of certain aspects of technology means that the shelf life of related areas of expertise among directors is much shorter than other highly prized skill sets. For example, directors who previously chaired a Big Four audit firm or who served as economists are likely to stay relevant for years by simply keeping up with changes, says Plotnick. But if directors' expertise is in big-data analytics and cloud computing, for instance, those areas evolve more rapidly.

On the other hand, sometimes boards need to do a better job of communicating and collaborating with management about where directors provide value, she says.

The complexity of the issue shows the need for boards to undergo yearly analyses of directors' skills, including a skills gap analysis, says **Margaret Pederson**, CEO of **Amirexx** and a director at **Viad**.

Plus, Plotnick says, a yearly "decode" of the company's strategy and the specific skills and expertise necessary to keep the board performing at a high level will help boards in their approach.

In addition, the process should be collaborative, says Pederson. The CEO and management team should weigh in.

Deborah Hicks Midanek, president of **Solon Group** and a former director on several boards, says that it's also helpful to take the issue to the full board for discussion rather than relying on only the nom-gov committee.

"This circumstance arises when everybody at the table has not disclosed what they think their expertise and everybody else's expertise actually is," Midanek says. "It's sort of a textbook case of a board not talking amongst themselves."

The Soft Stuff

Yet, at the same time there's a risk of focusing too intensely on the skills matrix and matching up areas of expertise with strategic plans, Midanek adds. One of the most important traits in a board member is the ability to have detached business judgment that is relevant to the company in its circumstances, she says.

However, explaining what "good judgment" is and why it is essential in a board member is difficult to write in a proxy, says Midanek, who advises distressed companies.

"It's very hard to write about it because it's so soft," says Midanek. "These are soft skills people are talking about when they say these things are hard to find in the American workplace today."

The focus on industry expertise and justifying every director's board seat, however, has raised the importance of boards' communicating how they approach composition to investors more clearly.

"It's not just skills but character and judgment that investors should want on the boards that they're invested in," says Midanek. "But this isn't physics, it's biology." ■

Amanda Gerut (212-542-1246 or agerut@AgendaWeek.com) covers succession planning, board composition and director pay.

Safety continued from page 1

individuals for corporate crimes, as articulated in the so-called Yates Memo, says **Warren Hamel**, chair of the investigations and white-collar practice at law firm **Venable**.

"Whether it's safety, environmental, financial or [other regulations], individuals are going to have to think a lot more carefully if they know things are not in compliance with the law, because there's not just going to be a fine for the company in the future," says Hamel.

"It puts individuals squarely in the target."

Safety Spotlight

Blankenship, who faces a year in jail pending a sentencing hearing in March, was not the only CEO found guilty of safety violations this year. In September, **Stewart Parnell**, former CEO of the Peanut Corporation of America, was sentenced to 28 years in prison after being found guilty of knowingly selling salmonella-tainted peanut butter that killed nine people and sickened 714 others in 2008 and 2009.

Blankenship is the first CEO of a major company to face criminal charges for workplace safety issues. Parnell is the first CEO to be found guilty of federal felony charges over food poisoning. Both are expected to appeal.

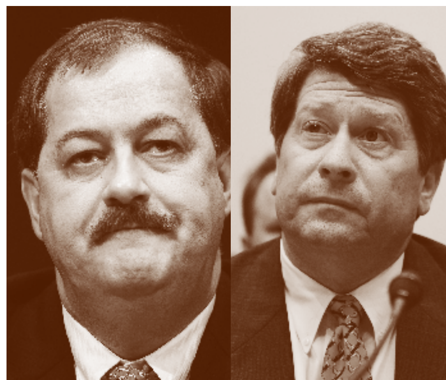
The auto industry also faced public scrutiny in 2015 over safety issues. For example, executives from airbag manufacturer **Takata** faced a Senate grilling in June for selling explosive airbags that killed eight people, leading to the largest recall ever in the U.S.

Regulatory fines on safety are also increasing this year. The bipartisan budget signed by President **Barack Obama** in November raised fines by the **Occupational Safety and Health Administration** for worker safety rule violations by up to 80%, the first OSHA fine increase since 1990. Instead of paying $70,000 per severe violation, companies will pay $125,000. Obama also signed into law this year stricter food safety regulations, which require more frequent inspections of food manufacturing plants.

Board Procedures

"It is incumbent on boards to know what the risks are," says **Andrea Bonime-Blanc**, CEO of **GEC Risk Advisory**. "It goes back to a topic that hasn't been properly addressed by a lot of boards of directors, and that is understanding the non-financial risks as well as the financial risks of companies."

Bonime-Blanc recommends the use of a risk committee to examine areas of non-financial risk more carefully.



Getty

Don Blankenship and Stewart Parnell

Boards in industries that are at high risk of safety issues should also develop a mission statement that includes leadership's commitment to health, safety and environmental issues, says **Mark Kaster**, a partner at **Dorsey & Whitney** who specializes in risk management in these areas. This will inform the company's policies on safety and accountability.

"Good companies undertake to evaluate their performance. They audit, monitor and verify that they are doing the right thing," he says.

Boards should make sure to ask for the standard metrics on safety issues that could affect their company, say experts. For example, typical worker safety metrics include the number of lost-time injuries at the company in a specific time frame and how long on average employees are out of work due to injuries. **Michael Schumann**, a professor in the safety, security and emergency management department at **Eastern Kentucky University**, says boards should then go one step further to compare company data to industry averages offered by OSHA or the **Department of Labor**.

They should also tailor their information requests to their industry, experts say. For example, the board of a company that runs call centers would want information on telephone line safety as well as metrics on physical office security, says **Deborah Hicks Midanek**, president and principal of **Solon Group**, a consulting firm that advises the boards of troubled companies.

"What happens a lot is that boards believe that their companies are being appropriately careful, when, in fact, they are looking at superficial kinds of risks and not necessarily tying risk to actual activity that's going on," says Midanek, who has served as a director on the boards of several private and public companies.

Directors should probe further into how safety metrics were produced, the qualifications of the person who produced them, and what relevance they have to the company, she adds.

"You have to ask one degree more than the question that is typically asked," says Midanek.

Internal Investigations

Bill Watts, a principal at **Crowe Horwath** and leader of internal audit services at the consulting firm, says boards should consider undertaking their own investigation following a safety failure at their company. They should be careful to note which regulators may also be looking into the issue. For example, he says, the DOJ or **SEC** will sometimes bar the board from retaining their own investigators.

"The board has a fiduciary responsibility to investigate once they start to get inquiries, because that usually indicates an investigation is on the way," he says. "But once it becomes official and the regulator notifies the organization, usually the board will step back because they don't feel they can muddy the water."

There were several investigations into Massey Energy after the disaster, including one initiated by the governor of West Virginia, **Joe Manchin**, and a federal investigation by the mining safety agency.

In 2011, Massey Energy shareholders filed an unsuccessful derivative action against directors of the company, contesting its sale to **Alpha Natural Resources**. Court papers reveal the inner workings of the board and the process it undertook after the Upper Big Branch mine disaster and ensuing investigations.

According to the ruling filed in May 2011 by **Leo Strine**, then vice chancellor of the **Delaware Court of Chancery**, the board had failed to comply with a 2008 court order to form a committee on safety, and safety metrics had deteriorated before the disaster.

After the disaster, independent directors on the board retained independent counsel in response to several derivative motions that had been filed.

The board also formed an advisory committee to consider the derivative claims and overtures from Alpha and other companies that were interested in buying Massey, and the committee retained its own outside counsel.

The board continued to stand behind Blankenship, who was opposed to a sale, for about six months following the disaster. But by fall 2010, it developed another committee to examine strategic alternatives for the company. In November 2010, the advisory committee determined that Blankenship's outspoken criticism of mining regulators was becoming undesirable and that the company did indeed have safety problems.

The board told Blankenship in December 2010 that it wanted to go through with a sale and asked him to resign, which he did, receiving a $12 million severance package. Blankenship was indicted in November 2014 for his handling of safety at the company.

"Safety issues are a director's worst nightmare," Midanek says.

If a board finds out its CEO is under investigation for safety issues, Midanek says it should form an independent committee to determine whether to ask the CEO to step aside or appoint an interim CEO if necessary. But, she says, this determination should be made on a case-by-case basis. ■

Melissa J. Anderson (212-542-1277 or manderson@AgendaWeek.com) covers legal, legislative and regulatory issues.

Agenda Education **The Board's Role in Long-Term Value Creation**

While a board is primarily responsible for providing management oversight, directors can also use their varied expertise to help the company create long-term shareholder value. Our panelists will discuss how directors can play a role in developing strategy without overstepping their bounds.

Date: January 26th

Time: 11:00 a.m. – 12:00 p.m. ET

Price: No additional cost; this is included in your *Agenda* subscription

Panelists:

Bill McCracken
Director at NACD,
Former CEO at CA Technologies

Gregg Walker
Senior VP, Corporate Development
at Sony Corporation of America

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the next 12 months may see boards going beyond "thinking like an activist" to addressing their composition. Strong companies as well as troubled ones are in the cross hairs, and traditional institutions as well as activists are the ones fixing the sights.

"The biggest change in the overall behavior of boards may come not from Sarbanes-Oxley and Dodd-Frank and people interested in good governance," says **Mark Nadler**, principal at **Nadler Advisory Services**, a board and executive consultancy firm. "It may in fact come from the influence of the marketplace making it clear to boards that they need to be doing what they should have been doing all along: thinking and acting on behalf of the shareholder."

Size was of no consequence to activists this year. DuPont, with a market cap of more than $60 billion, was one of the largest companies ever to defend itself in a proxy battle with an activist. It defeated **Nelson Peltz** — only to change CEOs and then pursue the Dow mega-deal anyway. Meanwhile, the $70 billion-plus **American International Group** faces a call by **Carl Icahn** to break itself into three parts.

In addition, Peltz's **Trian Fund Management** bought a stake in **General Electric**, which at more than $300 billion in market cap would be by **FactSet**'s measure the third-largest activist target, following campaigns by Icahn at **Apple** and **ValueAct Capital Management** at **Microsoft**.

Among companies with roughly $500 million or more in market cap, 160 faced a real challenge to their strategies so far this year, says **Jim Rossman**, head of corporate preparedness at **Lazard**. About 40% of those involved requests for board seats. Rossman counts 105 board seats this year that were filled due to activism. "Activists were more emboldened in 2015 to push their agenda," he says.

Given how many activist nominees are joining boards, incumbent directors may want to prepare themselves in case their boardroom is next, says **Deloitte Advisory Services** principal **Chris Ruggeri**. For example, boards may want to raise the minimum number of directors needed to call a board meeting or revisit the responsibilities for committee chairs.

"The advice that I would have given to my clients last year still stands," Ruggeri says. "The best defense is being prepared."

Activist funds still have plenty of cash in their war chests. Assets under management were almost $122 billion at the end of September, according to **HFR**. While that's up about only 2% from slightly more than $119 billion at the end of last year, it still towers over the roughly $51 billion the category held in 2011.

The results of a recent survey by **FTI Consulting** and **Activist Insight** reiterate the potential for a busy 2016 for activists. Of 24 activist firms responding, more than 85% indicated they plan to enter at least three new campaigns in the next 12 months. That's in keeping with this year, when 31 activist funds targeted three or more companies, according to FTI and Activist Insight.

The types of activists boards can expect in the year ahead fall in two categories. **David Hunker**, head of activism defense at **JPMorgan**, says the top tier of activists will be delivering "more nuanced, more complex" campaigns.

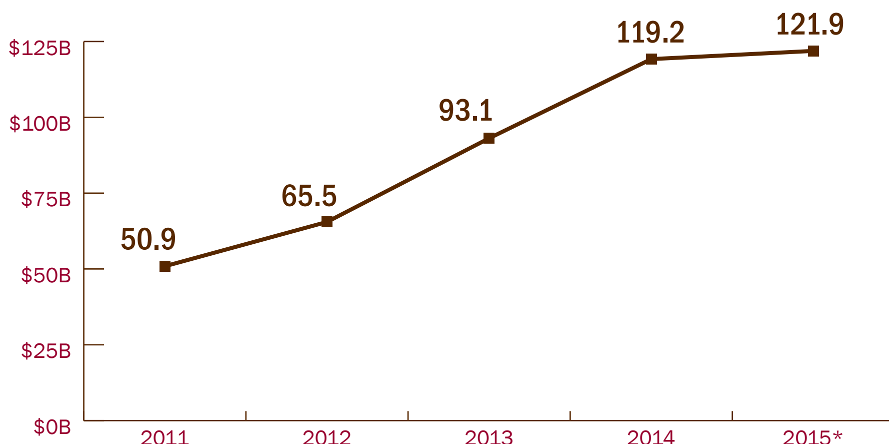
"On the other end of the spectrum," Hunker says, "given all of the new entrants into this activist space, we expect to see companies that maybe don't deserve the attention of a shareholder activist getting that attention."

Bruce Goldfarb, president and CEO of proxy solicitation firm **Okapi Partners**, has also noticed the arrival of activism newbies. "We're hearing from a lot of activists, even first-time activists, who are gearing up for proxy season next year," he says.

Behind both the additional strategic options available to sophisticat-

Activist Assets Continue to Rise

Estimated assets under management of activist hedge funds



Source: HFR

**Up to 9/30/2015*

ed activists and the chance that any company, no matter how well-run, might be a target, Lazard's Rossman cites the booming deal market. Mergers and acquisitions have totaled an annual record high of $4.6 trillion so far this year, according to **Dealogic**, with the booming market giving activists potential routes to unlocking shareholder value regardless of whether they found other faults with management's approach. "There's no wall around you," Rossman says.

Boards, too, became more sophisticated in their approach this year. More companies were willing to go all the way to a vote, not because they were blind to the activist threat but instead because they had engaged with shareholders and developed their own value-enhancement plan, says **Keith Gottfried**, head of the shareholder activism defense practice at **Morgan Lewis & Bockius**.

At the same time, where Gottfried used to say that the board of an activist target was typically fending off its first activist challenge while the activist fund was vastly more experienced, now more boards have members who have seen activists firsthand at other companies. "The companies are not as much sitting ducks as they used to be," he says.

Engagement is a major thread running through the year in activism, with Lazard's Rossman saying some directors attend "governance road shows" held by their companies with major shareholders. But beyond outreach, activism defense advisors expect board composition will be a bigger focus for companies in 2016.

As boards are forced to take a harder look within their own ranks, it may be fitting that proxy battles are predicted to become more personal, as well. "It's not just going to be a proxy contest about why their four candidates are great," JPMorgan's Hunker says of the activists. "It's going to be a proxy contest about why these four existing board members are terrible."

While that might hit a bit close to home, activism is also becoming increasingly global. **Dan Loeb**'s **Third Point** has drawn attention in Japan, while **Paul Singer**'s **Elliott Management** has been busy in South Korea. But "it's not a one-way street," says Hunker. "We are seeing some of the local non-U.S. activists start to target U.S. companies."

Activists aren't the only investors with clout in activist challenges, as highlighted by the decisive role traditional institutional investors played in DuPont's proxy contest. This month **Wachtell**, **Lipton**, **Rosen & Katz** founding partner **Martin Lipton** focused on the likes of **BlackRock**, **State Street** and **Vanguard** in his annual memo outlining thoughts for boards.

"What management teams and boards need to understand is that there are no more 'company-friendly investors,'" Hunker says. "Every institutional investor is willing to support a shareholder activist if they feel that shareholder activist has a shareholder-value-enhancing idea."

As the lines blur between activists and other investors, what boards are doing to address activists more clearly overlaps with what governance advocates were calling for them to do all along. "What activism has changed is — it's really caused there to be an acceleration of time frames," Ruggeri says.

"And the debate about strategic direction, which used to be contained to the boardroom and the management team, now can be in a broader forum." ■

Marc Hogan (mhogan@AgendaWeek.com) is *Agenda*'s news analyst.

Shareholder Intelligence

Activist Loeb Urges Dow CEO's Exit

As the business world digested **Dow Chemical**'s planned mega-merger with **DuPont**, activist investor **Dan Loeb** recommended the termination of Dow CEO **Andrew Liveris**.

In a private letter, the **Third Point** founder expressed support for the deal but challenged the timing of the announcement, *Crain's Detroit Business* reports, citing a person familiar with the matter. The merger became public two days before a standstill agreement between Dow and Loeb's hedge fund was to end. Loeb reportedly worries Dow might have rushed the deal to get in ahead of this expiration date.

Dow and DuPont have said their all-stock merger of equals would form a new entity called DowDuPont, which would later break up into three new businesses. Liveris, Dow's CEO and chairman, would become executive chairman of DowDuPont while DuPont chairman and CEO **Ed Breen** would be CEO.

Dow's board members "are unanimously and fully supportive of the announced merger," the company told *Crain's*. That includes two directors nominated by Third Point. Dow gave the hedge fund those seats in November 2014 as part of the standstill agreement, under which Third Point agreed not to criticize management or boost its stake for a year.

Meanwhile, **University of California, Berkeley** law professor **Steven Davidoff Solomon** panned the deal as potentially harmful financial engineering. Writing in *The New York Times*, the columnist says, "When historians look back at this era, they will see this deal as a turning point when corporate leaders threw up their hands and surrendered to activist shareholders."

— Marc Hogan

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NEWS ROUNDUP

Cheniere's Ousted CEO to Stay on Board

Cheniere Energy founder **Charif Souki** has lost his CEO and chairman titles, but will stay on as a director, according to filings.

As Bloomberg was first to report, Cheniere said on December 14 that its board had terminated Souki as CEO and removed him as director and chairman of the board. A day later, Cheniere said Souki would actually retain his seat on the board.

Keeping a seat in the boardroom is uncommon for an ousted CEO. Another CEO to have remained a director after being ousted is former **Healthsouth** boss **Richard Scrushy**.

Souki's interim successor as CEO is Cheniere board member **Neal Shear**, a former co-head of **Morgan Stanley**'s commodities arm. Another Cheniere director and Morgan Stanley veteran, **Andrea Botta**, takes over as chairman.

The board voted unanimously to replace Souki after a disagreement, following a clash with the board over the company's strategic direction, the *Financial Times* reports, citing a person familiar with the matter. The person said Souki had threatened to step down several times in the past year.

Carl Icahn, who became Cheniere's largest shareholder this summer and gained two board seats, praised the board for its "guts" in removing Souki.

Souki's ousting will result in roughly $165 million in exit pay, *The Wall Street Journal* reports, citing filings and people familiar with the matter.

Souki told Bloomberg, "I have a large amount of shares that don't vest for two and a half years, and I have a significant interest in knowing what direction they want to take the company."

Tumbling oil prices have driven Cheniere's share price down this year. The company is poised to be the first major U.S. exporter of liquefied natural gas.

Delaware Court Gets First African American Chancellor

The Delaware Chancery Court has sworn in new vice chancellor **Tamika Montgomery-Reeves**, the first African American and second woman on the influential court's bench, reports Law360.com.

Montgomery-Reeves, a former **Wilson Sonsini Goodrich & Rosati** partner, becomes the 38th judge in a history dating back to 1792 for the court, which is home to many major corporate cases. She fills an opening left by vice chancellor **Donald Parsons**, who retired in October.

Chancellor **Andre Bouchard**, referring to the historic significance of the occasion, said at the swearing-in ceremony, "Some say, 'Well, it is about time,' but I like to think we were just waiting patiently for the right person," as quoted by *The News Journal*.

Former chancellor **William Chandler** praised Montgomery-Reeves for her intellect and temperament. She clerked for Chandler, and the two worked together at Wilson Sonsini. Prior to joining the firm, she was in securities and corporate governance law at **Weil Gotshal & Manges**.

Gov. **Jack Markell** (D), who has now nominated all five of the court's sitting judges, described the newest member's "confident humility" and "remarkable ability to grasp the intricacies of corporate law."

The first woman on the Chancery bench was former Delaware Supreme Court Justice **Carolyn Berger**, who became a vice chancellor in 1984.

Markell may soon have the chance to name another Chancery judge. Vice chancellor **John Noble** recently announced plans to leave in February.

Markell chose Montgomery-Reeves from an all-female short list of qualified candidates, another first.

The new judge's docket includes some carryovers from the Parsons era, such as a shareholder lawsuit fighting the merger between **Expedia** and **Orbitz**. ■

— Marc Hogan

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