

## **Pending Legislation Could Bring Major Changes in Corporate Governance**

By Thomas W. White and Robert J. Teply<sup>1</sup>

Fallout from the financial crisis that began in late 2007 has led to a renewed legislative focus on corporate governance issues. While the current Congress has concentrated primarily on broader financial regulatory reform, pending legislation could result in the most dramatic changes in U.S. corporate governance practices since passage of the Sarbanes-Oxley Act in 2002. The comprehensive regulatory reform bill recently passed by the House of Representatives includes governance provisions that are not limited to financial institutions but would also apply to public companies generally. An omnibus reform bill proposed by Senate Banking Committee Chairman Christopher Dodd also contains corporate governance provisions, and a number of other prior pieces of legislation affecting governance remain pending.

Many of these proposals involve hot-button issues of executive compensation, including say on pay, compensation committee structure and powers and incentive compensation clawbacks. Other proposals represent corporate governance initiatives long advocated by certain institutional investors and others. These include proxy access, separation of the roles of board chair and chief executive officer, elimination of staggered boards and majority voting for directors.

If enacted, the pending legislative proposals could significantly increase the federal role in prescribing corporate governance standards and alter the governance landscape in key respects. This article describes the major governance provisions in these various legislative proposals.<sup>2</sup>

### **Pending Bills**

Corporate governance has been the subject of significant legislative activity in the 111th Congress. On December 11, 2009, the House passed the “Wall Street Reform and Consumer Protection Act of 2009,” H.R. 4173 (the Wall Street Reform Act). This bill included the provisions of the “Corporate and Financial Institution Compensation Fairness Act of 2009,” H.R. 3269, which the House previously passed on

July 31, 2009. The Corporate and Financial Institution Compensation Fairness Act itself incorporated the principal aspects of the Obama administration's legislative proposal on executive compensation, announced June 10, 2009.<sup>3</sup> In addition, Representatives Peters, Ellison and Kilroy have introduced standalone corporate governance bills.<sup>4</sup>

In the Senate, bills under consideration include Chairman Dodd's proposed "Restoring American Financial Stability Act of 2009," which has not yet been formally introduced; the "Excessive Pay Shareholder Approval Act," S. 1006, introduced May 7, 2009 by Senator Durbin; and the "Shareholder Bill of Rights Act of 2009," S. 1074, introduced May 19, 2009 by Senator Schumer.

### **Analysis of Corporate Governance Provisions**

#### *Say on Pay*

Most of the bills, including the Wall Street Reform Act and Chairman Dodd's bill, contain "say on pay" provisions.<sup>5</sup> These provisions apply to all companies that distribute proxies subject to the Securities and Exchange Commission's proxy rules, although some proposals would give the SEC authority to exempt companies from the new rules. Say on pay would require companies to have an annual stockholder vote to approve the company's executive compensation and related compensation disclosure. The stockholder vote would be advisory. According to the terms of the legislation, say on pay would not impose any new fiduciary duties on the company's board of directors.

Some companies already have experience with say on pay, and say on pay is a growing trend.<sup>6</sup> In addition, a number of stockholder proposals requesting that companies implement say on pay succeeded in 2009.<sup>7</sup> If say on pay is included in final legislation, this practice will become mandatory for companies subject to the SEC's proxy rules.

#### *Say on Parachutes*

The Wall Street Reform Act, Chairman Dodd's bill and several other bills also contain "say on parachutes" provisions.<sup>8</sup> Similar to say on pay, these provisions would apply to all companies subject to the SEC's proxy rules, although under some proposals, the SEC would have

authority to exempt companies from the new rules. Under the Wall Street Reform Act's version of say on parachutes, whenever these companies ask stockholders to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the company's assets, these companies must propose a stockholder vote to approve any agreement or understanding with certain executive officers concerning "any type of compensation (whether present, deferred, or contingent)" based on or related to the transaction.<sup>9</sup> As with say on pay, the stockholder vote would be advisory, and, according to the legislation, would not impose new fiduciary duties on directors.

The bills vary as to which employees say on parachutes would apply. The Wall Street Reform Act specifies the company's "named executive officers,"<sup>10</sup> while other bills, including Chairman Dodd's bill, specify the company's "principal executive officers."<sup>11</sup>

#### *Compensation Committee Independence*

The Wall Street Reform Act, Chairman Dodd's bill and other bills would require the board of directors of companies that, variously, have a stock-exchange listing or stock-exchange listed equity, to establish a compensation committee composed entirely of independent directors.<sup>12</sup> Although federal securities law, federal tax law and stock exchange rules already contain definitions of director independence, the bills may result in a new and stricter definition of independence for this purpose.<sup>13</sup> The Wall Street Reform Act, for example, would define compensation committee independence as a director not accepting "any consulting, advisory, or other compensation fee" from the company, except in the capacity as a director, a definition derived from the definition applied to audit committee members under the Sarbanes-Oxley Act. Other bills also include the second prong of the Sarbanes-Oxley definition applied to audit committee members, the requirement that the director not be an affiliated person of the public company, which could disqualify the representatives of large shareholders from serving on the compensation committee.

#### *Compensation Advisors*

The Wall Street Reform Act, Chairman Dodd's bill and other bills would require that companies grant the board's compensation

committee power to retain the committee's own advisors and further require that some or all of these advisors be independent.<sup>14</sup> For example, Senator Dodd's bill would require that "[a]ny compensation consultant, legal counsel, or other advisor to the compensation committee" be independent.<sup>15</sup> The Wall Street Reform Act does not require that legal counsel be independent. Under these provisions, the expense of these advisors must be borne by the company at the discretion of the compensation committee. The criteria for independence of compensation consultants and, if applicable, legal counsel would be established by SEC regulation.

#### *Compensation Clawbacks*

Chairman Dodd's bill and Representative Peters's bill would require exchange-listed companies to adopt executive compensation clawback policies.<sup>16</sup> Chairman Dodd's proposal would require repayment of the unearned portion of any incentive-based compensation by any current or former executive officer who received such compensation during the preceding three years if the company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement under the securities laws. These provisions would extend clawbacks applicable to recipients of assistance under the Trouble Asset Relief Program to all exchange-listed companies.

#### *Shareholder Proxy Access*

The Wall Street Reform Act, Chairman Dodd's bill and other bills explicitly authorize the SEC to promulgate proxy access rules, allowing shareholders to have their director nominees included in the company's proxy materials.<sup>17</sup> The SEC is currently considering a proxy access proposal.<sup>18</sup> Some constituents have asserted that the SEC lacks power to impose proxy access requirements; these bills would expressly confirm the SEC's power in this area.

#### *Independent Board Chair*

The bills proposed by Senator Schumer and Representatives Peters and Ellison would end the practice of permitting the chief executive officer to chair the board of directors. These bills would

require board chairs of exchange-listed companies to be independent directors.<sup>19</sup> Representative Peters's bill and Senator Schumer's bill specify that to be independent, the chair must never have been an executive officer of the company.<sup>20</sup> The more recent Dodd bill would not require an independent board chair, but instead would require disclosure in a company's annual proxy materials about whether or not the company has an independent board chair, and why. The SEC recently adopted such a disclosure requirement.<sup>21</sup>

#### *Annual Board Elections*

Senator Schumer's bill would outlaw staggered boards of directors at exchange-listed companies.<sup>22</sup> This provision would preempt state law provisions, such as Section 141(d) of the Delaware General Corporation Law, that permit staggered boards. Senator Dodd's bill would require shareholder approval for an exchange-listed company to have a staggered board.<sup>23</sup>

#### *Majority Vote Standard*

A growing trend at many public companies has been implementation of a majority vote standard in uncontested director elections, instead of the previously almost universal plurality standard. Senator Dodd's bill, Senator Schumer's bill and Representative Peters's bill would codify this trend for exchange-listed companies.<sup>24</sup> The proposal advanced by Senator Schumer would require the automatic resignation of a director who failed to obtain a majority vote in an uncontested election. Representative Peters's proposal and Senator Dodd's proposal would allow the board, subject to certain conditions, to decline to accept the resignation of a director who failed to obtain a majority vote for re-election.

#### *Board Risk Committee and Chief Risk Officer*

Some of the bills would require companies to form committees of the board dedicated to evaluating the company's risk management practices. Under this provision, the board would need to establish a "risk committee" (or "risk management committee") composed entirely of independent directors, responsible for the establishment and evaluation of the risk management practices of the company.<sup>25</sup> Rep. Ellison's bill

would require companies to have a chief risk officer, who would report directly to the board's risk management committee.<sup>26</sup> Senator Dodd's proposal, however, would only require a risk committee at financial institutions, and would not require the entire risk committee to be independent.

## **Conclusion**

Given the vagaries of the legislative process, it is difficult to predict whether some or all of these legislative corporate governance proposals will be adopted. The House's passage of the Wall Street Reform Act has given a substantial impetus to many of the governance proposals. Although some of the proposals are also included in the Dodd bill, the fate of these governance proposals in the Senate remains uncertain. To a great extent, the prospects of ultimate enactment will be subsumed in the larger issues regarding financial regulatory reform under consideration in Congress. Of course, another major financial crisis could galvanize support for immediate adoption of new legislation. In any event, the ultimate contours of any governance reform enacted into law will likely be defined by how the SEC implements those measures.

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<sup>2</sup> This article addresses selected provisions of pending federal legislation that would affect public companies generally. This article does not address industry-specific proposals, such as proposals that would only affect financial services companies.

<sup>3</sup> See Statement by Treasury Secretary Tim Geithner on Compensation (June 10, 2009).

<sup>4</sup> The "Shareholder Empowerment Act of 2009," H.R. 2861, introduced June 12, 2009 by Representative Peters; the "Corporate Governance Reform Act of 2009," H.R. 3272, introduced July 21, 2009 by Representative Ellison; and the "Proxy Voting Transparency Act of 2009," H.R. 3351, introduced July 27, 2009 by Representative Kilroy.

<sup>5</sup> S. 1074, § 3; H.R. 2861, § 3; H.R. 3272, § 5; H.R. 3351, § 2; H.R. 4173, § 2002; and the Restoring American Financial Stability Act of 2009 [hereinafter, "Dodd"], § 951 (available at <http://banking.senate.gov/>) (Dec. 23, 2009).

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<sup>6</sup> Approximately 30-50 public companies have voluntarily implemented say or pay (or announced plans to do so). In addition, the U.S. Treasury's Troubled Asset Relief Program, as amended, required participating companies to include say on pay. *See* American Recovery and Reinvestment Act of 2009, § 7001(e) (amending 12 U.S.C. § 5221(e)).

<sup>7</sup> These companies included CVS Caremark Corporation, Dow Chemical Company, Edison International, Honeywell International Inc., Prudential Financial, Inc. and Yum! Brands, Inc. RiskMetrics Group's U.S. Proxy Voting Guidelines generally recommend a vote in favor of stockholder proposals that call on companies to adopt say on pay.

<sup>8</sup> S. 1074, § 3; H.R. 3351, § 2; H.R. 4173, § 2002; and Dodd, § 952.

<sup>9</sup> The Dodd bill would apply to any proxy solicitation (rather than just those concerning transactions). Instead of referring to a "disposition of all or substantially of the company's assets," the Dodd bill refers generally to any "disposition." *See* Dodd, § 952.

<sup>10</sup> H.R. 4173, § 2002. *See* Regulation S-K Item 402(a)(3) (defining "named executive officers").

<sup>11</sup> S. 1074, § 2; H.R. 3351, § 2; and Dodd, § 952. It is unclear whether "principal executive officers" would include only the company's chief executive officer or a broader group.

<sup>12</sup> H.R. 3272, § 4; H.R. 4173, § 2003; and Dodd, § 953. If the company does not have a compensation committee, the bills generally require compensation matters to be determined solely by the independent directors of the board.

<sup>13</sup> *See, e.g.,* Securities Exchange Act § 10A(m)(3); NYSE Listed Company Manual Rule 303A.02; Internal Revenue Code § 162(m)(4)(C)(i).

<sup>14</sup> H.R. 2861, § 3; H.R. 4173, § 2003; and Dodd, § 953.

<sup>15</sup> Dodd, § 953.

<sup>16</sup> H.R. 2861, § 3; and Dodd, § 955.

<sup>17</sup> S. 1074, § 4; H.R. 2861, § 2; H.R. 4173, § 7222; and Dodd, § 972.

<sup>18</sup> *See* Facilitating Shareholder Director Nominations, Securities Act Release 33-9046, Exchange Act Release 34-60089 (June 10, 2009).

<sup>19</sup> S. 1074, § 5; H.R. 2861, § 2; and H.R. 3272, § 2.

<sup>20</sup> S. 1074, § 5; and H.R. 2861, § 2.

<sup>21</sup> *See* Proxy Disclosure Enhancements, Securities Act Release 33-9089, Exchange Act Release 34-61175 (Dec. 16, 2009).

<sup>22</sup> S. 1074, § 5.

<sup>23</sup> Dodd, § 974.

<sup>24</sup> S. 1074, § 5; H.R. 2861, § 2; and Dodd, § 971.

<sup>25</sup> S. 1074, § 5; *see also* H.R. 3272, § 3; and Dodd, § 107.

<sup>26</sup> H.R. 3272, § 3.