AMERICAN BANKRUPTCY INSTITUTE

Winter Leadership Conference

# The Importance of Corporate Controls: Failed Business Organizations

Hosted by the Bankruptcy Litigation & Commercial and Regulatory Law Committees


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The Importance of Corporate Controls – Failed Business Organizations

# SPEAKERS

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# The Internal Control Framework

Internal Control Framework:

- **Control Environment: sets tone of the organization**
- **Risk Assessment: especially as it relates to risks that might arise as a result of changes in the operating environment**
- **Control activities: policies and procedures put in place to ensure that management directives are carried out**
- **Information and communication**
- **Monitoring**

# Three Types of Corporate Controls


# Signs of Poor Corporate Controls

1. Unreasonably small accounting team.
2. No ERP system or a staff that does not use the ERP when one exists
3. Lack of accounting reconciliations.
4. A board that does not function properly (i.e. no regular meetings during which they discuss the company's financials, no audit committee, etc.)
5. The inability to produce a cash flow statement
6. No audit committee/audit committee dominated by insiders/audit committee comprised of people with insufficient financial expertise
7. No internal audit function for midsize companies and larger
8. Auditing firm insufficiently large or sophisticated given the size of the company
9. Lack of a whistleblower policy at mid size and large companies
10. Culture of hiding information

# The Board's Role

**The board exercises its oversight of financial controls through the audit committee.**

The responsibilities of the audit committee are:

1. Preparing the audit committee report in the proxy statement for a public company
2. Appointing, compensating, retaining, and overseeing the auditors
3. Establishing the company's whistleblowing process
4. Engaging independent counsel and other advisors as needed
5. Reviewing and discussing financial statements
6. Meeting separately with management, with internal auditors, ands with independent auditors
7. For public companies, discussing earnings releases and financial information given to analysts
8. Discussing risk management and risk assessment strategies
9. Reporting to the full board
10. Evaluating itself

# Governance Failures in the Enron Case

**Fiduciary failure –**
**the board did not fill its fiduciary role**

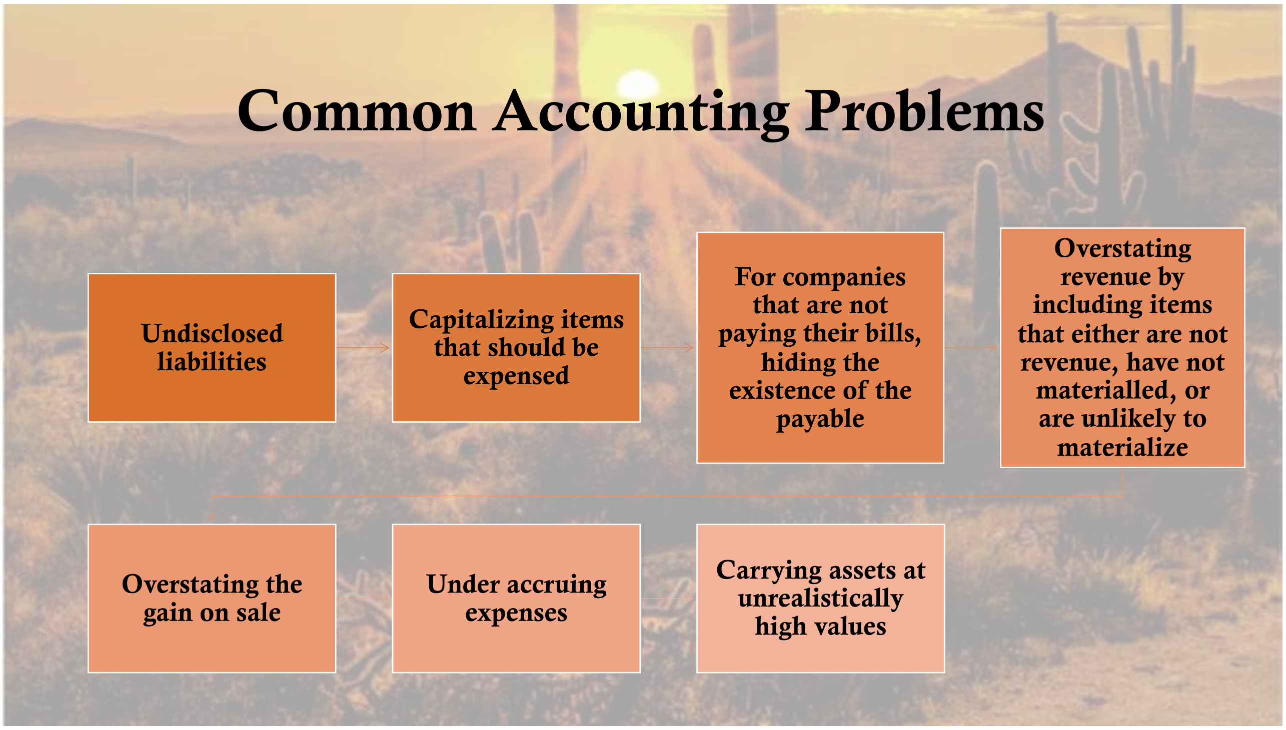
**High risk accounting –**
**the audit committee allowed the company to use mark to market accounting in order to record future profits as current profits**

**Excessive undisclosed off the books activity –**
**Enron did not report many of its liabilities**

**Inappropriate conflicts of interest –**
**the CFO had business interests that profited from the company to the company's detriment.**

**Excessive compensation –**
**executives were draining the company's finances with their pay packages while the CEO received a multi-million loan from the company**

**Lack of independence –**
**the board was not independent and the auditors were also engaged in consulting projects to earn extra money from the company**


Common Accounting Problems
Undisclosed liabilities
Capitalizing items that should be expensed
For companies that are not paying their bills, hiding the existence of the payable
Overstating revenue by including items that either are not revenue, have not materialled, or are unlikely to materialize
Overstating the gain on sale
Under accruing expenses
Carrying assets at unrealistically high values

**Summary/Key Points of Discussion**

**Topic: The Importance of Corporate Governance Controls and the Specific Measures That Could Prevent a Company's Failure**

By adhering to governance principles, companies can build stronger, more resilient structures that prioritize long-term success over short-term gains, thereby reducing the likelihood of business failures and increasing accountability.

In light of the WorldCom Collapse in 2002, the director of the SEC at the time, Richard Breeden ("Breeden") created a detailed report, titled, "Restoring Trust" that included 78 recommendations developed pursuant to the terms of the Permanent Injunction issued in November 2002 by the Hon. Jed S. Rakoff of the United States District Court for the Southern District of New York in connection with the enforcement proceeding brought against WorldCom by the United States Securities and Exchange Commission. The Permanent Injunction and subsequent Orders of the Court required the development of recommendations intended to prevent any reoccurrence of the governance abuses that were instrumental in the collapse of WorldCom and continues to serve as the kitchen sink of corporate governance recommendations. Of those 78 recommendations, Breeden was able to narrow the recommendations into several broad themes which include:

1. Establishment of a Governance Constitution for the Company.
2. More Shareholder Communications.
3. Selection of Directors (require at least one new director to be elected each year. For the first time, a group of shareholders will have the power, if it does not agree with proposed candidates to fill board vacancies, to nominate their own candidates for inclusion in the management proxy statement. This will mean that unless a mutually acceptable compromise is reached, there will be a contested election for filling the vacancies in that year. In that event shareholders will have a genuine choice of whom to select. In addition, there are important qualification standards that any director must meet.)
4. An Active, Informed and Independent Board.
5. A Non-Executive Chairman of the Board of Directors.
6. Active Board Committees. (Required to have an Audit Committee, Governance Committee, Compensation Committee and a Risk Management Committee. The CEO will not serve as a member of any of these committees, so that each is composed entirely of independent directors.).

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7. Term Limits and Auditor Rotation. (Directors limited to a maximum term of ten years in office. In addition, the independent auditors of the Company will also be limited to a maximum term of ten years before a required rotation of auditors must occur.).
8. Compensation Limits. (The board will be required to establish a maximum compensation level for any individual in any year without shareholder approval. The recommended starting level is not more than $15 million, though the board will be free to set a lower number. No executive can be granted more than this amount in any year, including cash, equity grants, and all other forms of remuneration, without a vote of the shareholders. Most "retention" grants are banned, maximum dollar limits are placed on severance awards, and so-called "evergreen" contracts are prohibited. All personal use of corporate aircraft and other corporate assets is prohibited).
9. Equity Compensation Programs.
10. Enhanced Transparency, Internal Controls and Finance Department.
11. Legal Compliance, an Enhanced Legal Department, and Ethics Programs.
12. Change in Control Devices. (The objective of any such programs should be to ensure that if any transaction occurs in the future, all shareholders will have an equal opportunity to participate and to share in any control premium.)

In 2018, approximately twenty high-profile CEOs - including Warren Buffett - published Commonsense Principles of Corporate Governance 2.0 and implementing these principles could significantly mitigate the risk of business failure and promote sustainable success. Here's a summary of specific measures companies should consider based on these principles:

**1. Board of Directors – Duties, Composition, and Internal Governance:**

- **Duties of Loyalty and Care:** Directors must be accountable to shareholders and evaluated based on the company's long-term performance.

- **Composition:** Emphasize the importance of independent directors, their integrity, competence, diversity, and skill sets. It encourages a subset of directors with direct business-related experiences.

- **Elections of Directors:** Advocates for directors' election by majority votes cast, ensuring accountability. For example, companies should:

    - In uncontested elections, directors should be elected by a majority of the votes cast "for" and "against/withhold" (i.e., abstentions and non-votes should not be counted for this purpose). An individual director who fails to receive such a majority should tender an offer of resignation. The board ordinarily should accept the resignation; if it does not, it should clearly explain its rationale to the company's shareholders.

- No matter how frequently a company chooses to elect directors, a director ordinarily should refrain from joining a board on which he or she is not committed to serving for at least three years.

- Requiring all directors to stand for election on an annual basis may help promote board accountability to shareholders. If a company chooses to hold elections on a staggered basis or otherwise elect directors less frequently than annually, the board should explain clearly (ordinarily in the company's proxy statement) its rationale for doing so.

- **Nominating Directors:** Encourages board responsibility for nominating qualified directors, potentially considering long-term shareholders' recommendations.

- **Director Compensation and Stock Ownership:** Emphasize fair compensation, stock ownership, and aligning directors' interests with long-term company performance.

    - Companies should consider paying a substantial portion (e.g., for some companies, as much as 50% or more) of director compensation in stock or similar equity-like instruments. Companies also should consider requiring directors to retain a significant portion of their equity compensation for the duration of their tenure to further directors' economic alignment with the long-term performance of the company.

- **Board Committee Structure and Service:** Calls for a robust orientation program for new directors and a clear committee structure with defined responsibilities. For example, companies should:

    - Companies should conduct a thorough orientation program for their new directors, including background on the industry and the competitive landscape in which the company operates, the company's business and operations, important legal and regulatory issues, etc.

    - A board should have a well-developed committee structure with clearly understood responsibilities. Disclosures to shareholders should describe the structure and function of each board committee.

    - Boards should consider periodic rotation of board leadership roles (i.e., committee chairs and the lead independent director), balancing the benefits of rotation against the benefits of continuity, experience and expertise.

**2. Board of Directors' Responsibilities:**

- **Director Communication with Third Parties:** Highlights the importance of effective communication with shareholders and media.

- **Critical Activities of the Board; Setting the Agenda:** An Agenda should provide for a means to advocate for a forward-looking discussion of business, CEO performance evaluation, creation of shareholder value, strategic issues, risks, and more.

    - It is important that companies engage with shareholders and receive feedback about matters relevant to long-term shareholder value.

    - Shareholder proposals. In the event that a company receives a shareholder proposal, it should consider engagement with the proposing shareholder (as well as other shareholders, to the extent appropriate) early in the process, preferably before the proposal appears in the proxy. Should the proposal receive majority shareholder support, the company should consider further engagement with shareholders and either implement the proposal (or a comparable alternative) or promptly explain why doing so would not be in the best long-term interests of the company. As a best practice, the company also should consider further engagement with shareholders to discuss shareholder proposals that receive significant but less than majority support and formulate an appropriate response. And while such response may include the adoption of the proposal (or a comparable alternative), the board should be mindful of the fact that a majority of the company's shareholders did not support the proposal.

    - At each meeting, to ensure open and free discussion, the board should meet in executive session without the CEO or other members of management. The independent directors should ensure that they have enough time to do this properly.

    - In addition to its other responsibilities, the audit committee should focus on whether the company's financial statements would be prepared or disclosed in a materially different manner if the external auditor itself were solely responsible for their preparation.

**3. Shareholder Rights:**

- Encourage proxy access, equal treatment of shareholders in corporate transactions, and provisions for written consent and special meetings.

- Dual class voting is not a best practice. If a company has dual class voting, which sometimes is intended to protect the company from short-term behavior, the company ordinarily should have specific sunset provisions, based upon time or a triggering event, which would eliminate dual class voting. In addition, all shareholders should be treated equally in any corporate transaction.

**4. Public Reporting:**

- Stress transparency in quarterly financial reporting, framing it within the broader context of the company's strategy and long-term goals.

  - A company should frame its required quarterly reporting in the broader context of its articulated strategy and provide an outlook, as appropriate, for trends and metrics that reflect progress (or not) on long-term goals. A company should not feel obligated to provide quarterly earnings guidance – and should determine whether providing quarterly earnings guidance for the company's shareholders does more harm than good. If a company does provide quarterly earnings guidance, the company should be realistic and avoid inflated projections. Making short-term decisions to beat guidance (or any performance benchmark) is likely to be value destructive in the long run.

  - Companies are required to report their results in accordance with Generally Accepted Accounting Principles ("GAAP"). While it is acceptable in certain instances to use non-GAAP measures to explain and clarify results for shareholders, such measures should be sensible, and companies should provide a bridge from non-GAAP items to the most comparable GAAP items, so as not to obscure GAAP results. In this regard, it is important to note that all compensation, including equity compensation, is plainly a cost of doing business and should be reflected in any non-GAAP measurement of earnings in precisely the same manner it is reflected in GAAP earnings.

**5. Board Leadership:**

- Emphasize independent leadership and the roles of the chair, CEO, and a lead independent director.

  - Independent leadership of the board is essential to a well-functioning board and, in particular, effective oversight of the company and its management. There are two common structures for independent board leadership in the U.S.: (1) an independent chair; or (2) a lead independent director.

- The board's independent directors should decide, based upon the circumstances at the time, whether it is appropriate for the company to have separate or combined chair and CEO roles. The board should periodically review its leadership structure and explain clearly (ordinarily in the company's proxy statement) to shareholders why it has separated or combined the roles, consistent with the board's oversight responsibilities.

- If a board decides to combine the chair and CEO roles, it is critical that the board has in place a strong designated lead independent director and governance structure. The role of the lead independent director should be clearly defined and sufficiently robust to ensure effective and constructive leadership. The responsibilities of the lead independent director and the executive chair should be clearly delineated, agreed upon by the board, and disclosed to shareholders.

**6. Management Succession Planning:**

- Having a robust process for succession planning is extremely important:
    - Senior management bench strength can be evaluated by the board and shareholders through an assessment of key company employees; direct exposure to those employees is helpful in making that assessment.
    - Companies should inform shareholders of the process the board has for succession planning and also should have an appropriate plan if an unexpected, emergency succession is necessary.

**7. Compensation of Management:**

- Emphasize competitive and tailored compensation plans, aligning with long-term performance and considering a significant portion of compensation in stock or equity.

**8. Investors' Role in Corporate Governance:**

- Encourages asset managers and institutional asset owners to exercise voting rights thoughtfully, engage with companies, consider long-term value creation, and disclose proxy voting processes.

Implementing these measures comprehensively can significantly enhance corporate governance, fostering a culture of accountability, transparency, and long-term value creation. This, in turn, could potentially prevent business failures by ensuring sound decision-making, effective oversight, and alignment with shareholder interests.

# COMMONSENSE PRINCIPLES 2.0

The following is a series of corporate governance principles for public companies, their boards of directors and their institutional shareholders (both asset managers and asset owners). These principles are intended to provide a basic framework for sound, long-term-oriented governance. Given the differences among U.S. public companies – including their size, products and services, geographic footprint, history, leadership and ownership – we recognize that not every principle will be applied in the same fashion (or at all) by every company, board or shareholder. Nonetheless, we intend to use these principles to guide our thinking.

## I. Board of Directors – Duties, Composition and Internal Governance

### a. Duties of Loyalty and Care

- Directors are accountable to shareholders and owe duties of loyalty and care to the company. Directors' performance should be evaluated through the company's long-term performance, financial and otherwise.

### b. Composition

- A board must not be beholden to the CEO or management. A significant majority of the board (and all of the members of the audit, compensation and nominating and governance committees of the board) should be independent, consistent with the New York Stock Exchange rules or similar standards.

- All directors must have high integrity and the appropriate competence to represent the interests of all shareholders in achieving the long-term success of their company. Ideally, in order to facilitate engaged and informed oversight of a company and the performance of management, a subset of directors will have professional experiences directly related to the company's business. At the same time, however, it is important to recognize that some of the best ideas, insights and contributions can come from directors whose professional experiences are not directly related to the company's business.

- Independent directors should be just that: strong and steadfast, independent of mind and willing to challenge the CEO and other directors constructively – concepts that may not be fully reflected in black-and-white rules. At the same time, directors should not be divisive or self-serving. Collaboration and collegiality also are critical for a healthy, functioning board.

- Directors should be business savvy and shareholder-oriented, and have a genuine passion for their company.

- Directors should have complementary and diverse skill sets, backgrounds and experiences. Diversity along multiple dimensions, including diversity of thought, is critical to a high-functioning board. Director candidates should be drawn from a rigorously diverse pool.

- While no one size fits all – boards need to be large enough to allow for a variety of perspectives, as well as to manage required board processes – a board generally should be as small as practicable so as to promote an open dialogue among directors.

- Directors need to commit substantial time and energy to the role. Therefore, a board should assess the ability of its members to maintain appropriate focus and not be distracted by competing responsibilities. In so doing, the board should carefully consider a director's service on multiple boards and other commitments. While senior managers of other companies may be time constrained, they may be able to offer unique insights and otherwise add significant value to a board.

c. Elections of directors

- It is a fundamental right of shareholders to elect directors whom they believe are best suited to represent shareholder interests.

- In uncontested elections, directors should be elected by a majority of the votes cast "for" and "against/withhold" (i.e., abstentions and non-votes should not be counted for this purpose). An individual director who fails to receive such a majority should tender an offer of resignation. The board ordinarily should accept the resignation; if it does not, it should clearly explain its rationale to the company's shareholders.

- No matter how frequently a company chooses to elect directors, a director ordinarily should refrain from joining a board on which he or she is not committed to serving for at least three years.

- Requiring all directors to stand for election on an annual basis may help promote board accountability to shareholders. If a company chooses to hold elections on a staggered basis or otherwise elect directors less frequently than annually, the board should explain clearly (ordinarily in the company's proxy statement) its rationale for doing so.

d. Nominating directors

- A company's board is responsible for nominating qualified directors consistent with the criteria for board composition set forth in I.b ("Composition") above.

- Long-term shareholders should recommend potential directors for the board's consideration if they know the individuals well and believe they would be additive to the board.

- A company is more likely to attract and retain strong directors if the board focuses on big-picture issues and can delegate other matters to management (see below at II.b., "Critical activities of the board; setting the agenda").

e. Director compensation and stock ownership

**COMMONSENSE PRINCIPLES 2.0**

- A company's independent directors should be fairly and equally compensated for board service, although (i) lead independent directors and committee chairs may receive additional compensation, and (ii) committee service fees may vary. If a director receives any additional compensation from the company that is not related to the director's service as a board member, such activity should be disclosed and explained.

- Companies should consider paying a substantial portion (e.g., for some companies, as much as 50% or more) of director compensation in stock or similar equity-like instruments. Companies also should consider requiring directors to retain a significant portion of their equity compensation for the duration of their tenure to further directors' economic alignment with the long-term performance of the company.

f. Board committee structure and service

- Companies should conduct a thorough and robust orientation program for their new directors, including background on the industry and the competitive landscape in which the company operates, the company's business and operations, important legal and regulatory issues, etc.

- A board should have a well-developed committee structure with clearly understood responsibilities. Disclosures to shareholders should describe the structure and function of each board committee.

- Boards should consider periodic rotation of board leadership roles (i.e., committee chairs and the lead independent director), balancing the benefits of rotation against the benefits of continuity, experience and expertise.

g. Director tenure and retirement age

- It is essential that a company attract and retain strong, experienced and knowledgeable board members.

- Some boards have rules around maximum length of service and mandatory retirement age for directors; others have such rules but permit exceptions; and still others have no such rules at all. Whatever the case, companies should clearly articulate their approach on term limits and retirement age. And insofar as a board permits exceptions, the board should explain (ordinarily in the company's proxy statement) why a particular exception was warranted in the context of the board's assessment of its performance and composition.

- Board refreshment should always be considered in order to ensure that the board's skill set and perspectives remain sufficiently current and broad in dealing with fast-changing business dynamics. But the importance of fresh thinking and new perspectives should be tempered with the understanding that age and experience often bring wisdom, judgment and knowledge.

h. Director effectiveness

- A board should have a robust process to evaluate itself on a regular basis, led by the non-executive chair, lead independent director or appropriate committee chair. The board should have the fortitude to replace ineffective directors.

II. Board of Directors' Responsibilities

a. Director communication with third parties

- Robust communication of a board's thinking to the company's shareholders is important. On some issues, such as board governance and CEO compensation, direct communication from the board may be warranted. Companies may wish to designate certain directors to do so – as appropriate and in coordination with management. Directors who communicate directly with shareholders ideally will be experienced in such matters.

- Directors should speak about the company with the media only if authorized by the board and in accordance with company policy.

- In addition, the CEO should actively engage on corporate governance and key shareholder issues (other than the CEO's own compensation) when meeting with shareholders.

b. Critical activities of the board; setting the agenda

- The full board (including, where appropriate, through the non-executive chair or lead independent director) should have input into the setting of the board agenda.

- Over the course of the year, the agenda should include and focus on the following items, among others:

  ❖ A robust, forward-looking discussion of the business.

  ❖ The performance of the current CEO and other key members of management and succession planning for each of them. One of the board's most important jobs is making sure the company has the right CEO. If the company does not have that CEO, the board should act promptly to address the issue.

  ❖ Creation of shareholder value, with a focus on the long term. This means encouraging the sort of long-term thinking owners of a private company might bring to their strategic discussions, including investments that may not pay off in the short run.

  ❖ Major strategic issues (including material mergers and acquisitions and major capital commitments) and long-term strategy, including thorough consideration of operational and financial plans, quantitative and qualitative key performance indicators, and assessment of organic and inorganic growth, among others.

- The board should receive a balanced assessment on strategic fit, risks and valuation in connection with material mergers and acquisitions. The board should consider establishing an ad hoc transaction committee if significant board time is otherwise required to consider a material merger or acquisition. If the company's stock is to be used in such a transaction, the board should carefully assess the company's valuation relative to the valuation implied in the acquisition. The objective is to properly evaluate the value of what you are giving vs. the value of what you are getting.

- Significant risks, including reputational risks. The board should not be reflexively risk averse; it should seek the proper calibration of risk and reward as it focuses on the long-term interests of the company's shareholders.

- Standards of performance, including the maintaining and strengthening of the company's culture and values.

- Material corporate responsibility matters.

- Key shareholder concerns.

  a. It is important that companies engage with shareholders and receive feedback about matters relevant to long-term shareholder value.

  b. *Shareholder proposals.* In the event that a company receives a shareholder proposal, it should consider engagement with the proposing shareholder (as well as other shareholders, to the extent appropriate) early in the process, preferably before the proposal appears in the proxy. Should the proposal receive majority shareholder support, the company should consider further engagement with shareholders and either implement the proposal (or a comparable alternative) or promptly explain why doing so would not be in the best long-term interests of the company. As a best practice, the company also should consider further engagement with shareholders to discuss shareholder proposals that receive significant but less than majority support and formulate an appropriate response. And while such response may include the adoption of the proposal (or a comparable alternative), the board should be mindful of the fact that a majority of the company's shareholders did *not* support the proposal.

  c. *Management proposals.* Similarly, in connection with a management proposal, the company should consider engagement with shareholders early in the process. Should the proposal be defeated or receive significant shareholder opposition, the company should consider further engagement with shareholders and formulate an appropriate response, again mindful of how a majority of the company's shareholders voted.

❖ The board (or appropriate board committee) should:

a. determine the best approach to compensate management, taking into account all the factors it deems appropriate, including corporate and individual performance and other qualitative and quantitative factors; and

b. discuss and approve the CEO's compensation.

See below at VII ("Compensation of Management").

- A board should be continually educated on the company and its industry, seeking information from a variety of sources, including research reports, audit reports and, where relevant, regulatory pronouncements. If a board feels it would be productive, outside experts and advisors should be brought in to inform directors on issues and events affecting the company.

- The board should minimize the amount of time it spends on frivolous or non-essential matters – the goal is to provide perspective and make decisions to build real value for the company and its shareholders.

- As authorized and coordinated by the board, directors should have unfettered access to management, including those below the CEO's direct reports.

- At each meeting, to ensure open and free discussion, the board should meet in executive session without the CEO or other members of management. The independent directors should ensure that they have enough time to do this properly.

- In addition to its other responsibilities, the audit committee should focus on whether the company's financial statements would be prepared or disclosed in a materially different manner if the external auditor itself were solely responsible for their preparation.

III. Shareholder Rights

a. Public companies should allow for some form of proxy access, subject to reasonable requirements that do not make proxy access unduly burdensome for significant, long-term shareholders. Among the larger market capitalization companies that have adopted proxy access provisions, generally a shareholder (or group of up to 20 shareholders) that has continuously held a minimum of 3% of the company's outstanding shares for three years is eligible to include on the company's proxy statement nominees for a minimum of 20% (and, in some cases, 25%) of the company's board seats. A higher threshold of ownership (e.g., 5%) often has been adopted for smaller market capitalization companies (e.g., less than $2 billion). In either case, as a general matter, only shares in which the shareholder has a full, unhedged economic interest should count toward satisfaction of the ownership/holding period requirements.

b. Dual class voting is not a best practice. If a company has dual class voting, which sometimes is intended to protect the company from short-term behavior, the company ordinarily should have specific sunset provisions, based upon time or a triggering event, which would eliminate dual class voting. In addition, all shareholders should be treated equally in any corporate transaction.

c. Written consent and special meeting provisions can be important mechanisms for shareholder action. Where they are adopted, there should be a reasonable minimum amount of outstanding shares required in order to prevent a small minority of shareholders from being able to abuse the rights of other shareholders or waste corporate time and resources.

d. Poison pills and other anti-takeover measures can diminish board and management accountability to shareholders. Insofar as a company adopts a poison pill or other anti-takeover measure, the board ordinarily should put the item to a vote of the shareholders and clearly explain why its adoption is in the best interests of the company's shareholders. On a periodic basis, the board should review such measures to determine whether they remain appropriate.

IV. Public Reporting

a. Transparency around quarterly financial results is important.

b. A company should frame its required quarterly reporting in the broader context of its articulated strategy and provide an outlook, as appropriate, for trends and metrics that reflect progress (or not) on long-term goals. A company should not feel obligated to provide quarterly earnings guidance – and should determine whether providing quarterly earnings guidance for the company's shareholders does more harm than good. If a company does provide quarterly earnings guidance, the company should be realistic and avoid inflated projections. Making short-term decisions to beat guidance (or any performance benchmark) is likely to be value destructive in the long run.

c. As appropriate, long-term goals should be disclosed and explained in a specific and measurable way.

d. A company should take a long-term strategic view, as though the company were private, and explain clearly to shareholders how material decisions and actions are consistent with that view.

e. Companies should explain when and why they are undertaking material mergers or acquisitions, major capital commitments or significant restructuring or cost-savings initiatives.

f. Companies are required to report their results in accordance with Generally Accepted Accounting Principles ("GAAP"). While it is acceptable in certain instances to use non-GAAP measures to explain and clarify results for shareholders, such measures should be sensible, and companies should provide a bridge from non-GAAP items to the most comparable GAAP items, so as not to obscure GAAP results. In this regard, it is important to note that *all* compensation, including equity compensation, is plainly a cost of doing business and should be reflected in any non-GAAP measurement of earnings in precisely the same manner it is reflected in GAAP earnings.

V. Board Leadership (Including the Lead Independent Director's Role)

a. Independent leadership of the board is essential to a well-functioning board and, in particular, effective oversight of the company and its management. There are two common structures for independent board leadership in the U.S.: (1) an independent chair; or (2) a lead independent director.

b. The board's independent directors should decide, based upon the circumstances at the time, whether it is appropriate for the company to have separate or combined chair and CEO roles. The board should periodically review its leadership structure and explain clearly (ordinarily in the company's proxy statement) to shareholders why it has separated or combined the roles, consistent with the board's oversight responsibilities.

c. If a board decides to combine the chair and CEO roles, it is critical that the board has in place a strong designated lead independent director and governance structure. The role of the lead independent director should be clearly defined and sufficiently robust to ensure effective and constructive leadership. The responsibilities of the lead independent director and the executive chair should be clearly delineated, agreed upon by the board, and disclosed to shareholders.

d. Depending on the circumstances, a lead independent director's responsibilities may include:

- Serving as liaison between the chair and the independent directors.
- Presiding over meetings of the board at which the chair is not present, including executive sessions of the independent directors.
- Ensuring that the board has proper input into meeting agendas for, and information sent to, the board.
- Having the authority to call meetings of the independent directors.

**COMMONSENSE PRINCIPLES 2.0**

- Insofar as the company's board wishes to communicate directly with shareholders, engaging (or overseeing the board's process for engaging) with those shareholders.
- Guiding the annual board self-assessment.
- Guiding the board's consideration of CEO compensation.
- Guiding the CEO succession planning process.

VI. Management Succession Planning

a. Senior management bench strength can be evaluated by the board and shareholders through an assessment of key company employees; direct exposure to those employees is helpful in making that assessment.

b. Companies should inform shareholders of the process the board has for succession planning and also should have an appropriate plan if an unexpected, emergency succession is necessary.

VII. Compensation of Management

a. To be successful, companies must attract and retain the best people – and competitive compensation of management is critical in this regard. To this end, compensation plans should be appropriately tailored to the nature of the company's business and the industry in which it competes. Varied forms of compensation may be necessary for different types of businesses and different types of employees. While a company's compensation plans will evolve over time, they should have continuity over multiple years and ensure alignment with long-term performance.

b. Compensation should have both a current component and a long-term component.

c. Benchmarks and performance measurements (financial and otherwise) ordinarily should be disclosed to enable shareholders to evaluate the rigor of the company's goals and the goal-setting process. That said, compensation should not be entirely formula based, and companies should retain discretion (appropriately disclosed) to consider factors that may not be easily measured, such as integrity, work ethic, effectiveness, openness, etc. Those matters are essential to a company's long-term health and ordinarily should be part of how compensation is determined.

d. Companies should consider paying a substantial portion (e.g., for some companies, as much as 50% or more) of compensation for senior management in the form of stock, performance stock units or similar equity-like instruments. The vesting or holding period for such equity compensation should be appropriate for the business to further senior management's economic alignment with the long-term performance of the company. With properly designed performance hurdles, stock options may be one element of effective compensation plans, particularly for the CEO. All equity grants (whether stock or options) should be made at fair market value, or higher, at the time of the grant, with particular attention given to any dilutive effect of such grants on existing shareholders.

e. Companies should clearly articulate their compensation plans to shareholders. While companies should not, in the design of their compensation plans, feel constrained by the preferences of their competitors or the models of proxy advisors, they should be prepared to articulate how their approach links compensation to performance and aligns the interests of management and shareholders over the long term. If a company has well-designed compensation plans and clearly explains its rationale for those plans, shareholders should consider giving the company latitude in connection with individual annual compensation decisions.

f. Grants to management of large special compensation awards (not normally recurring annual or biannual awards, but those considered special awards or special retention awards) should be carefully evaluated and reserved for special circumstances. The rationale for special awards to the CEO and other "Named Executive Officers" whose compensation is set forth in the company's proxy statement should be clearly explained.

g. Companies should maintain clawback policies for both cash and equity compensation.

VIII. Investors' Role in Corporate Governance

a. Asset managers

- On behalf of their clients, asset managers are significant owners of public companies and, therefore, often are in a position to influence the corporate governance practices of those companies and otherwise encourage companies and their boards to focus on long-term value creation.

- Asset managers should exercise their voting rights thoughtfully, devoting sufficient time and resources to evaluate matters presented for shareholder vote in the context of long-term value creation. Asset managers should actively engage, as appropriate, based on the issues, with the management and board of the company, both to convey the asset manager's point of view and to understand the company's perspective. Ideally, such engagement will occur early in the process to facilitate alignment on resolution of issues where possible and avoid unnecessary disruption. Asset managers should give due consideration to the company's rationale for its positions, including its perspective on certain governance issues where the company might take a novel or unconventional approach.

- Given their importance to long-term investment success, proxy voting and corporate governance activities should receive appropriate senior-level oversight by the asset manager.

- Asset managers, on behalf of their clients, should evaluate the performance of boards of directors, including thorough consideration of the following:

- To the extent directors are speaking directly with shareholders, the directors' (i) knowledge of their company's corporate governance and policies, and (ii) interest in understanding the key concerns of the company's shareholders.

- The board's focus on a thoughtful, long-term strategic plan and on performance against that plan.

- An asset manager's ultimate decision makers on proxy issues important to long-term value creation should have access to necessary information about the company. Asset managers with significant share ownership should have access to the company's management and, in some circumstances, the company's board. Similarly, a company, its management and board should have access to an asset manager's ultimate decision makers on those issues.

- Asset managers should raise critical issues to companies (and vice versa) as early as possible, in a constructive and proactive way. Building trust between shareholders and the company is a healthy objective.

- Asset managers may rely on a variety of information sources to support their evaluation and decision-making processes. While data and recommendations from proxy advisors may form pieces of the information mosaic on which asset managers rely in their analysis, ultimately, their votes should be based on independent application of their own voting guidelines and policies. To the extent they use recommendations from proxy advisors in their decision-making processes, asset managers should disclose that they do so, and should be satisfied that the information upon which they are relying is accurate and relevant. Proxy advisors whom they use should have in place processes to avoid or mitigate conflicts of interest.

- Asset managers should make public their proxy voting process and voting guidelines and have clear engagement protocols and procedures. They should disclose their policies for dealing with potential conflicts in their proxy voting and engagement activities.

- Asset managers should consider sharing their issues and concerns (including, as appropriate, voting intentions and rationales therefor) with the company (especially where they oppose the board's recommendations) in order to facilitate a robust dialogue if they believe that doing so is in the best interests of their clients.

- Compensation of portfolio managers investing in public companies should be structured to consider performance over an appropriate term, given the strategy and investment time horizon applicable to the portfolio. Ordinarily, that will mean using performance benchmarks over three- and five-year periods (and other periods, as appropriate) – as well as a one-year period – for some portion of a portfolio manager's compensation.

b. Institutional asset owners

- Institutional asset owners such as pension plans and endowments are in a position to influence public companies either directly (insofar as they direct their own investments) or through their interactions with asset managers (insofar as those managers invest on their behalf). In either case, such asset owners can use their position to advance sound and long-term oriented corporate governance. When investing through asset managers, owners may wish to encourage such practices through, for example:

    - the use of benchmarks and performance reports consistent with the asset owner's strategy and investment time horizon

    - interactions and dialogue with asset managers concerning corporate governance issues; and

    - the evaluation of asset managers on how they discharge their own role in corporate governance matters, as set forth above in VIII.a ("Asset managers").

# Faculty

**Eric A.W. Danner, CPA, CIRA, CTP** is a partner in the Restructuring and Dispute Resolution Practice of CohnReznick LLP in New York. He has more than 25 years of experience providing financial consulting and economic analysis to public and privately held companies. Mr. Danner's industry experience includes consumer, distribution, environmental services, financial services, health care, industrial, manufacturing, media, real estate, retail, technology, telecommunications, textiles and transportation. He has advised crisis-management situations by creating and implementing turnaround business plans, and has acted in chief restructuring officer (CRO), chief financial officer (CFO) and chief operating officer (COO) roles in both out-of-court and bankruptcy contexts. He also is experienced in providing a variety of fiduciary services, including wind-down leadership, litigation management and creditor claims resolution. Mr. Danner received his B.A. from Vassar College and his M.B.A. from Boston University.

**Heidi J. Sorvino** is the managing partner of the New York office of White and Williams LLP, where she practices financial restructuring and bankruptcy. She also is supervising partner of the firm's Financial Restructuring and Bankruptcy Group. Ms. Sorvino has decades of experience counseling clients dealing with distressed debt. She concentrates on corporate restructurings, complex bankruptcy and insolvency proceedings. Ms. Sorvino represents creditors and debtors through all phases of bankruptcy proceedings both inside and outside of the courtroom. She is appointed to serve as a subchapter V and chapter 11 trustee, and she represents distressed companies, creditors, insurance companies, financial institutions, hedge funds, distressed-debt investors and indenture trustees through negotiations to avoid the courtroom and to understand changing and emerging legal/regulatory issues. Ms. Sorvino has appeared as a guest on Reuters Television, Bloomberg TV and Fox Business News. She also has been quoted in the *Wall Street Journal*, *Crain's New York Business* and Dow Jones Newswire. Ms. Sorvino is AV-rated by Martindale-Hubbell and is listed in *The Best Lawyers in America* and *Super Lawyers*, among others. Beyond her client work, she mentors junior lawyers and members of the professional community. In 2014, she delivered the commencement address and was awarded a Doctor of Laws Degree, *honoris causa*, from the College of St. Elizabeth for her commitment to the practice of law and promoting women as full partners in the workplace. Ms. Sorvino received her B.A. in 1983 from Hamilton College, her M.S.W. in 1985 from New York University's Graduate School of Social Work and her J.D. in 1989 from St. John's University School of Law.

**Marc Sullivan, CFA, CTP** is CFO of Infinity Engineered Products in Mableton, Ga., and has served as Chief Executive Officer, Chief Restructuring Officer and Chief Financial Officer of both public and private companies experiencing significant challenges, including financial and operational restructuring in both the U.S. and abroad. He has three decades of experience in domestic and international finance, having lived and worked in the U.S., France, South Africa and Kenya and on projects in more than 20 countries. Mr. Sullivan also served as CFO of Western Global Airlines before and during its chapter 11 proceedings and Kabbage, Inc. (dba KServicing) during its chapter 11 proceedings. He currently sits on the global board of trustees of the Turnaround Management Association and is a member of its executive board. Mr. Sullivan received his B.A. in finance from Morehouse College and his M.B.A. from Harvard Business School.

**April A. Wimberg** is a partner at Dentons Bingham Greenbaum in Louisville, Ky., and has commercial and bankruptcy litigation experience. Her representations include creditors, committees, debtors, trustees and other interested parties involved in litigation arising out of corporate insolvencies. She also has assisted organizations in wind-down operations, serving as a receiver and advisor. Ms. Wimberg has experience obtaining temporary restraining orders, injunctions and writs in matters where assets are at risk of being concealed or diminished. Her representations include a wide array of industries, including coal, hemp, health care, retail, tobacco, manufacturing and commercial real estate. Prior to joining the firm, Ms. Wimberg spent 10 years working on Wall Street and in corporate strategy for *Fortune* 50 companies, where she gained experience in reviewing loan transactions and identifying business issues in litigation and opportunities with distressed assets. She has assisted companies across the globe with a wide range of business services and also served as a Peace Corps volunteer in the small business enterprises group in west Africa. Ms. Wimberg received her B.A. in political science in 2000 from the University of Kentucky and her J.D. in 2013 from the University of Louisville.