Business Law

Published by the Business Law Section of the Washington State Bar Association Volume 33, Number 1 • Winter 2010-2011

Business Succession Planning: Constructing and Implementing a Succession Plan for Closely Held and Family Businesses

by Andrew Heinz and Garon Jones[1] – Stokes Lawrence Velikanje Moore & Shore, P.S.

Business succession planning is a critical, but often overlooked, responsibility of successful small business owners. In many cases, the equity that the owners have created in the company will be the cornerstone of their personal financial plans in retirement. Many of these owners have talked with their estate planning advisors about their vision for what should happen upon their own retirement, death or disability. However, those assumptions, expectations, and goals need to be brought to the attention of the business attorney so that the business succession plan is coordinated with the owners' estate plan and personal financial plan.

Why Is Succession Planning Important Now?

Succession planning is important for closely held businesses because it ensures that the company, which the owners have spent years or decades devoted to growing and developing, survives the departure of the owners. In fact, succession planning is an emergent need for the majority of family businesses. Studies indicate that there will be a significant transition of power within family-owned businesses over the next few years. One study indicates that more than half of CEOs at family owned businesses plan to retire in the next 10 years.[2] Despite this plan for departure, there is often a failure to name a successor CEO.

- 55% of CEOs in family-owned businesses who are older than 60 have not chosen a successor.[3]
- 28% of CEOs aged 56-60 who plan to retire within five years have not chosen a successor.[4]
- 45% of CEOs aged 56-60 who plan to retire within ten years have not named a successor.[5]

Begin the discussion by asking a simple question: *"Do you want your business to continue after your involvement ends?"* As soon as the client is ready to answer this question in the affirmative, it is a good time to start developing a business succession plan. Often, however, business owners begin to think about succession planning only when their own retirement is imminent and it is too late to take the steps needed to make the plan successful. As discussed below, it can take years to implement the various elements of a succession plan. Encourage your clients to start now.

Four Important Elements of Business Succession Plan

Although each business succession plan will be multifaceted and tailored to the owners' and company's unique circumstances, there are several elements that are likely to emerge in most successful succession plans. Four important elements of a business succession plan are:

(1) Clearly articulated goals with respect to the owners *and* the company;

(2) Transition of ownership, especially in the context of family-owned business;

(3) Development of leadership to facilitate the succession plan; and

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(4) Relinquishment of control by the existing owners.

Start with Generating Clearly Articulated Goals.

Every successful succession plan requires that the client and the attorney have a clear understanding of the long-term goals of the owners and the company. You can begin with asking the owners some basic questions.

- How long do you want to be actively involved in the daily operations of the business?
- Are you positioning the company for sale?
- Are there children or other family members who will take over the business?
- Do you have someone in mind to succeed you in senior management of the company?

It is important to remember that your clients are wearing many hats, especially if it is a family-owned business. In addition to owning the company, they are probably actively involved in the daily management of the company. They are employers. Many will be parents. Some might be remarried, with children from a prior marriage. They might have siblings or in-laws in the company. Beyond all these roles, most will want to plan for their future role as a retiree. These different perspectives will likely produce a variety of expectations and goals that may not always be consistent.

As the attorney, go beyond your technical drafting skills and expertise as an advisor, and embrace the role as legal counselor. This involves active listening and reality checking with the client to obtain a better understanding of multiple perspectives. Drill down to get an understanding of the underlying motivations. Listen to what your clients say, but also pay close attention what they do *not* say in these discussions. From this you can identify issues that need to be resolved, even if the issues cannot be answered immediately or directly by the owners.

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At this level of the process, it is appropriate to get others involved in the process.

- The **accountant** or **chief financial officer** will often have extremely valuable input about the company that may not come up in conversations with the owners.[6]
- If the plan involves transfers of ownership to children through gift, bequest, or sale, it would be appropriate to ensure both **husband and wife** (owners) are involved in the goal-setting process.
- **Insurance agents** can be important to the coordination and design of the succession plan if life or disability insurance will be used to redeem or buy stock from the owners upon the happening of specified events.
- **Personal financial planners** may be helpful in reality checking the owners' assumptions about their current retirement savings or future liquidity needs.
- It may be appropriate to involve the **future owners**, whether children or employees**,** in some of these discussions so they understand the plan for the ongoing viability of the company after the current owners' departure.

The owners' goal setting must be vetted against the business realities of the company. Are the growth or income projections for after the owners' departure reasonable? Will the company be able to afford the terms of a redemption of the owners' stock? Addressing the goals and projections of the company is just as important as learning about the owners' goals when crafting a business succession plan.

Transition of Ownership

A second important element of a business succession plan is the timing and method of transferring ownership in the company. This will differ based on the goals of the plan.

Keep Until Death

One option is for the clients to retain ownership and control until their deaths. If they own 100% of the company, then they may have the foundation of their succession plan in their Wills. For example, the Wills might provide that:

(a) the ownership in the company pass to the children equally;

(b) the ownership goes to one or more children working in the business, but excludes non-employed children; or

(c) the ownership pass to a trust for the benefit of family members, thus giving them the economic benefit, but not full control of the rights associated with ownership.

If they co-own the company with others, then the provisions of a buy-sell agreement may provide for a transfer of ownership and management to the surviving owners via a corporate redemption or a purchase of the ownership interest by the surviving owners. In this case, life insurance proceeds might be relied upon to provide immediate liquidity for the deceased owners' family.

Under these planning scenarios, it is important to review the estate planning documents, life insurance ownership, and buy-sell agreements or operating agreements to ensure they are consistent. Issues to consider include:

- Does the buy-sell agreement allow for bequests?
- Would a bequest to a trust terminate the S-Corporation election for the company, or is the trust a qualified S-Corporation shareholder?
- If the Corporation owns life insurance, are the appropriate notices and reports being made[7]?
- If there is cross-owned life insurance, what is the plan for the insurance on the surviving owners?
- Is there a "transfer for value" issue that needs to be addressed?[8]

The point here is that even with a conceptually simple plan ("keep until death"), there is still a lot of reality checking and plan coordination that the attorney and other advisors can help the clients accomplish.

Lifetime Transfer to Kids

Another common approach for the succession plan is for owners to make a transfer of ownership, during their lifetime, to their children. Whether this should be accomplished as a gift, a sale, or a combination of the two is a decision that is based on a variety of factors.

Often, in order to allow the parents to retain control, the company is restructured to divide ownership into voting and non-voting classifications, with the children receiving the non-voting ownership interests. Again, the issue of whether trusts are appropriate (and with respect to S-Corporations, whether they are eligible shareholders) will arise.

Rather than transferring most or all of the ownership immediately, the transfers could occur over time. The subsequent cash flow to the children generated by the transferred ownership transferred can be instrumental in paying for life insurance premiums or the purchase of future ownership interest from the parents.

Whether by sale or gift, it will be important to obtain an accurate valuation of the transferred ownership interests. The discounts for lack of marketability and for minority interest/lack of control can be significant. Consultation with an attorney with a strong background in estate planning would be appropriate in this context to present options beyond the

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straight gift or sale to children, as well as to review the current transfer tax laws.

In addition to considering transfer taxes, clients are often interested in techniques that maximize income tax benefits. Sophisticated estate planning techniques such as a sale to an Intentionally Defective Grantor Trust can be explored as the business succession plan is solidified and being implemented.[9] At this stage of the implementation, consult with the owners' estate planning advisors to coordinate techniques that have an estate planning and a business succession planning purpose.

Lifetime transfers to, or for the benefit of, the owners' children will affect the ownership of the company and the economic situation of the owners and their family. However, the issue of who will succeed the owners in their management role still needs to be considered.

Development of Leadership

A third important element of a succession plan, which occurs during the implementation phase, is the development of leadership within the company to facilitate the succession plan. Regardless of the techniques used to transfer ownership, a succession plan is founded on the assumption that the business will continue beyond the involvement of the current owners.

More than 80% of businesses are still controlled by their founders.[10] But only about 30% of family-owned businesses survive to the second generation. This drops to 12% at the third generation.[11] Although there are numerous factors that influence this survival rate, these statistics illuminate the importance of planning for the departure of the owners and the need to replenish the variety of skills and experience they bring to the business.

Increased use of board meetings can facilitate the transition in leadership. One study on family-owned businesses indicates that almost half the boards met only once or twice a year.[12] Another 13% indicate that their boards never meet.[13] A more structured approach to addressing policy-level and strategic decisions will benefit the successor leaders. Board meetings can also reinforce the need to keep an eye on components of the succession plan and provide a regular forum for addressing related issues on a timely basis. Also, the named successor's attendance at meetings of the board or senior management allows other key employees to develop rapport and loyalty that may help keep those key employees at the company after the owners' departure.

Relinquishing Control by the Current Owners.

A final element of a successful business succession plan is the owners' willingness to release control to the new owners and management team identified in the plan. Depending on the personality of the current owner, this is sometimes easier said than done. The process of developing the succession plan, in collaboration with the clients and other advisors, and the implementation of that plan over time in a way that fulfills the stated goals will hopefully provide most clients with the comfort to relinquish control to the next generation of owners and management.

Conclusion

Business succession planning begins with an attorney asking a business owner a simple question, but the process can be challenging to complete because it often involves relinquishing control or transferring equity to another. These are obstacles, but obstacles that should be confronted in order to ensure the business's longevity. Completing the process requires the attorney to utilize a variety of skills, not only to help the clients understand the issues from multiple perspectives, but to keep the clients on track and not the let the process become stagnant. In doing so, the attorney has a unique opportunity to add value and foster a more trusted relationship with the clients.

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Mr. Jones' full profile is available at *http://www.stokeslaw.com/bio-jones.php*.

2 One study indicates that CEOs' responses in 2002 were that 56% will retire within 10 years. Furthermore, in a related 1997 survey, 53% of CEOs planned to retire within 10 years. Raymond Institute / Mass Mutual, American Family Business Survey (2003) at 11, available at *http://www3.babson.edu/ESHIP/ife/upload/American-Family-Business-Survey.pdf*.

3 Id.

4 Id.

5 Id.

6 This survey indicates that twice as many CEOs name their accountant (34.6%) as their "most trusted business advisor" than their attorney (17.1%). However, when it comes to business succession planning, accountants and attorneys rank almost equally. American Family Business Survey at 21.

7 Internal Revenue Code (26 U.S.C.) §§ 101(j) and 6039I. *See also* Internal Revenue Service Form 8925.

8 Internal Revenue Code (26 U.S.C.) § 101(a)(2).

9 A full discussion of Intentionally Defective Grantor Trusts is beyond the scope of this article. However, despite the use of the term "defective" in its name, an IDGT is specifically designed to be the best of both worlds for transfer tax (completed gift for gift tax purposes) and income tax (no capital gain recognized on a sale, and also eligible to own S-Corporation stock).

10 American Family Business Survey, *supra*, at 1.

11 Blueprints for Business, *White Paper on Family Business Succession Planning* (2009) at 4, available at *http://www.blueprintsforbiz.com/papers/business_succession.pdf* (October 25, 2010). *See also* Ibrahim, Nabil A., John P. Angelidis, Faramarz Parsa, *Strategic Management of Family Businesses: Current Findings and Directions for Future Research*, International Journal of Management, Vol. 25, No. 1 (March 2008) at 101.

12 American Family Business Survey, *supra*, at 2.

13 Id.

The Staggered Board Structure Under Scrutiny: Pros, Cons and Other Considerations

by Jaclyn N. Lasaracina†

In May 2009, Senator Charles Schumer of New York introduced The Shareholder Bill of Rights Act of 2009, co-sponsored by Washington's Senator Maria Cantwell.[1] The bill addressed an issue of particular interest to public corporations – board classification. Among many proposed changes, the Shareholder Bill of Rights took aim at classified, or staggered, boards of directors – boards with multiple classes of directors on which each class of directors serves for a two- to three-year term. The bill would have eliminated classified boards by requiring *all* directors of public companies to stand for election *annually*.[2] Due to substantial overlap with Senators Dodd and Frank's Wall Street Reform and Consumer Protection Act,[3] however, the Shareholder Bill of Rights was superseded, and the Dodd-Frank bill did not incorporate a provision prohibiting board classification.

Notwithstanding this latest development, there has been increasing momentum behind board declassification in the past ten years, and recently, more of that momentum is coming from boards themselves. Since 2005, boards (as opposed to shareholders) of S&P 1500 companies have submitted an average of 37 proposals for declassification per year, with a peak of 46 submitted in 2006.[4] Of the 29 board-submitted proposals on declassification in 2009, 25 were adopted.[5] Reports indicate that 64% of S&P 500 and 50% of S&P 1,500 companies elect directors annually.[6] That leaves a significant number of companies that still have classified boards. As discussed below in more detail, these companies still see many benefits—from continuity of oversight to better bargaining strength in the face of a hostile takeover—to retaining a classified board structure. Yet shareholder activists and many institutional shareholders oppose classified boards because they believe such a structure entrenches management and may deter takeover offers that would be beneficial to shareholders. Indeed, under RiskMetrics Group's Governance Risk Indicators, or GRId, regime, launched in March 2010, having a classified board results in a company receiving -5 points, while electing directors annually garners 5 points.[7] A RiskMetrics Group publication cites two studies from 2005 and 2007, respectively, which RiskMetrics Group believes show a correlation between a classified board structure and a reduction in firm value.[8]

Directors of public companies are increasingly scrutinized by government, the media, and investors alike. The enhanced proxy disclosure rules which took effect in February 2010, for example, require companies to disclose the "specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director" as well as how diversity is considered in the selection of board members.[9] And the specter of proxy access[10] suggests that the competitiveness of director elections may soon increase. Shareholders want directors who bring expertise but are not perceived as part of the establishment or entrenched in management ideas and practices. The annual election of directors is perceived as a way to improve investor relations by enhancing director accountability to shareholders.

Given shareholder and political hostility toward classified boards, the boards of companies that retain a classified structure face tough questions about whether to change to annual director elections. To aid these boards (and the lawyers who counsel them), this article will provide an overview of current declassification trends in Washington, what Washington companies have been saying about declassification, and issues companies should consider when thinking about board structure.

Current Declassification Trends in Washington

To help Washington companies benchmark board structure, we reviewed proxy statements filed from January 2000 to May 2010 by public companies located in Washington for discussion of board declassification. We found 43 instances of proposals for board declassification since 2000.[11] Although the average was four declassification proposals per year, the number peaked in 2005 with 12 proposals.

The year 2005 marked a turning point with regard to board sentiment about declassification. Since then, the boards of Washington companies have been more likely to submit the question of declassification to shareholders of their own volition (as opposed to merely including proposals submitted by shareholders). Of the 27 declassification proposals presented since 2005, 12, or 44%, were submitted by the board. Of the 27 total declassification proposals submitted since 2005 (by either the board or a shareholder), boards recommended approval in 11, or 41% of, instances. And of these 12 submitted by the board, the board recommended shareholder approval in 11, or 91%, of instances (in one board-sponsored proposal, the board offered no recommendation).

Contrast pre-2005, when only two boards submitted declassification proposals to their shareholders, and the remaining 14 were submitted by shareholders. Of the total submissions to shareholder vote, the board recommended approval only once, or 7% of the time.

Pros and Cons to Classified Boards

What have Washington boards of directors been saying about board structure? Boards that opposed declassification defended the staggered election of directors by presenting a variety of perceived benefits. Unsurprisingly, many boards discussed unsolicited takeover offers.[12] Declassified boards have traditionally been viewed as the cornerstone of

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a defense wall against hostile takeovers. To be sure, board declassification can serve this purpose – when directors are elected annually, a majority of the board can be replaced by a potential acquirer in one election.[13] Many boards stated that their staggered elections decreased vulnerability to unsolicited takeover proposals that are not in the best interest of the shareholders. The fact that the board cannot be replaced through a single proxy fight gives the directors the time and leverage necessary to evaluate the adequacy and fairness of the proposal, consider alternatives and ultimately negotiate the best result for the shareholders. Several boards were careful to note, however, that classification does not prevent or preclude unsolicited takeover attempts, but rather empowers the directors to negotiate terms to maximize the value of the transaction and encourages potential acquirers to initiate arm's-length discussions with the board. Several boards cited studies which, according to their interpretation, suggest that shareholders of target companies with classified boards receive more value at a liquidity event than shareholders of target companies with annual director elections.[14]

The other pro-classification considerations discussed by boards dealt with continuity and long-term strategic planning. According to these boards, classification tends to foster the stability of management and business policies because, at any given time, a majority of directors have experience and familiarity with the business and affairs of the company. In addition, the board can oversee multi-year implementation of projects and evaluate progress over time. Further, classification encourages the development of long-term strategies and policies because directors are able to make decisions without the pressure of annual elections, which can breed shortsightedness. And on a related note, several boards of directors noted that classification reduces the possibility of a sudden or surprise change in majority control.

Other boards asserted that staggered elections increase the independence of non-employee directors from special interest groups and others with interests that are contrary to the long-term interest of the company. In addition, these boards noted that classification enhances director independence from management, allowing board members to oppose management and face less of a threat of not being re-nominated. Several boards also stated that staggered elections help attract and retain highly qualified, committed individuals who are willing to dedicate the time necessary to understand the relevant industry and business.

Finally, numerous boards engaged the most common argument employed against classification – director accountability. These boards asserted that directors are always required to act in the best interest of the shareholders and the company in accordance with their fiduciary duties. It was further noted that shareholders have other ways to ensure the accountability of directors, such as withholding votes, launching publicity campaigns and meeting with directors.

Of the boards that recommended shareholder approval of annual director elections, most all expressed concern for shareholder perception and investor expectations related to corporate governance practices. Several boards noted that corporate governance standards have evolved such that many investors and commentators believe the election of directors is the primary means for shareholders to influence corporate governance policies and increase board and management accountability to shareholders. Other boards noted that classification may be viewed as reducing the accountability of directors because it limits the ability of shareholders to evaluate each director annually. A few boards stated that classification may increase the difficultly of or discourage removing incumbent directors and, thus, could have the effect of entrenching incumbents. Finally, several companies took the traditional basis for classified boards head-on, asserting that staggered elections could have the effect of discouraging a third party from making a tender offer or otherwise attempting to gain control even though such an attempt might be beneficial to the company and its shareholders.

As the pros and cons discussed above demonstrate, that there is no 'one size fits all' for board structure – a company's needs vary and change over time. During trying economic times, a company may be best served by a classified board that would be better able to fend off bottom-feeder potential acquirers. Conversely, if a board is under fire from shareholder activists, it may want to consider declassification to improve shareholder perception of director accountability.

Process Considerations for Declassification Proposals

When a board decides to review its structure, therefore, it should consider the arguments discussed above and determine what is in the best interest of the company and its shareholders. If a board decides to pursue declassification, there are several process issues it should consider.

The board must first decide the form of proposal to submit to shareholder vote. Proposals on declassification may be divided into two categories: those which ask the board to take the steps necessary to amend governance documents to eliminate classification and those which, following approval and recommendation by the board, ask the shareholders to approve an amendment to governance documents eliminating classification. Under Delaware law, board classification must be set out in either the certificate of incorporation or bylaws, Del. Code Ann. tit. 8, § 141(d) and, if in the certificate of incorporation, may only be amended with shareholder approval, Del. Code. Ann. tit. 8, § 242. Bylaw provisions may, by their own terms, require shareholder approval as well, but this is not statutorily required. Under Washington law, board classification must be set out in the articles of incorporation, Wash. Rev. Code § 23B.08.060, and, therefore, may only be amended by shareholder vote, Wash. Rev. Code § 23B.10.010

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(though many companies address board classification in both their articles and bylaws).

Of the proposals presented by boards since 2005, approximately 85% asked for shareholder approval of amendments to governance documents.

Boards must also determine the best timeline for declassification. Our review of proxy statements reveals four different options.

- First, a company may declassify as of the meeting when declassification is approved. Directors whose terms were not expiring would be asked to tender their resignations in advance of the meeting, and all directors would be elected for a one-year term.
- Alternatively, the board may wish to transition to a declassified structure gradually. Some companies have elected directors whose terms expired at the meeting when declassification was approved for one-year terms and subsequently asked all other directors to tender their resignations in advance of the following annual meeting such that declassification was implemented at that later annual meeting.
- A board may also choose to elect directors for a one-year term at the meeting at which declassification was adopted and allow all other directors to serve until their terms expired such that the board was still classified for two years following the adoption of declassification.
- Finally, for those directors elected at the meeting at which declassification is adopted, the board may opt to elect them for the same term as other directors and elect all other directors to one-year terms on a rolling basis as their present terms expire.[15]

Of the 43 Washington proxy statements reviewed, 28, or 65% of the proposals submitted to shareholder vote would have implemented declassification gradually.[16] All proposals for immediate declassification were presented between 2004 and 2007.

A Cautionary Tale

The "right" decision as to whether to have a classified or declassified board is particular to each individual company and the point in time at which the decision is made. One universal rule, however, is that companies should review any classified board language currently in their governance documents and prepare amendments to governance documents (if needed) with great care. The consequence of failing to do so may be observed in the drama of Air Products and Chemicals, Inc.'s attempt to takeover Airgas, Inc. through a hostile tender offer. *Airgas, Inc. v. Air Products and Chemicals, Inc.*, 2010 WL 3960599 (Del. Ch. 2010).

Going into its September 2010 stockholder meeting, Airgas's board of directors had nine members and was divided into three equal classes – one class of directors was elected each year. Air Products nominated three candidates for director and proposed three amendments to the company's bylaws – Air Products won all three seats to the board. The amendment challenged by Airgas in Delaware court set the date of the 2011 stockholder meeting to January 18, 2011. With majority approval, this amendment moves the 2011 stockholder meeting to just four months after the 2010 meeting, allowing Air Products to nominate and potentially gain three more seats, for a total of six of nine, on the Airgas board of directors. The Airgas bylaw which set the term of the classified board read that each class shall "hold office for a term expiring at the annual meeting of stockholders held in the third year following the year of their election." Neither "annual" nor "year" were defined in the Airgas articles of incorporation or bylaws. Chancellor Chandler of the Delaware Court of Chancery ruled that, faced with ambiguity, these terms should be read in favor of franchise rights and upheld the amendment. Chancellor Chandler reasoned that, as used in the Airgas governance documents, "annual" meant "once a year" and not "separated by approximately twelve months" such that the 2011 stockholder meeting could be moved to January 2011 and the class of directors elected in 2008 would, consistent with the bylaws, be up for re-election in the "third year following the year of their election." [17]

As the *Airgas* case makes clear, poor drafting or ambiguous language can lead to undesirable legal and business consequences. On this, Chancellor Chandler wrote:

> This [ruling] will not diminish the effectiveness of staggered boards. … If corporate charters and bylaws have been written in a non-specific, open-ended fashion, it is not for this court to twist their plain words to achieve a purported intent of the drafters. The solution is for the drafters to employ clear and simple language to provide clarity and avoid ambiguity. This could easily be accomplished by corporate planners and draftsmen through such simple language as: "The annual shareholder meeting shall be held as closely as practicable to the same month of each year so as to ensure that the terms of office of directors shall approximate a complete year in length.

Id., at *13.

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1 S. 1074, 111th Cong. (2009).

2 The November 2009 iteration of the Wall Street Reform and Consumer Protection Act contained a scaled-back restriction on classified boards; it prohibited securities exchanges from listing a company with a classified board unless shareholders had approved the board structure. This restriction did not make it into the final bill.

3 H.R. 4173, 111th Cong. (2010).

4 Georgeson, 2009 Annual Corporate Governance Review at 42.

5 *Id.* at 43.

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6 *See* M. Lipton, J. Lorsch and T. Mirvis, *A Crisis Is a Terrible Thing to Waste: The Proposed "Shareholder Bill of Rights Act of 2009" Is a Serious Mistake* (May 2009).

7 RiskMetrics Group, Governance Risk Indicators (March 10, 2010), available at *http://www.riskmetrics.com/sites/default/files/ISS_GRId_Tech_Doc_20100310.pdf*.

8 *Id.*

9 Rules 401(e)(1), Rule 407(c).

10 Proxy access would require companies to include shareholder nominees for director on the company's proxy card rather than the shareholder bearing the cost of sending his or her own proxy card. Congress granted the Securities and Exchange Commission the authority to implement proxy access in the Dodd-Frank bill.

11 Several companies had declassification proposals in multiple years such that fewer than 43 companies had declassification proposals on their proxy statements.

12 The adoption of a staggered board as a defensive tactic is currently playing out in the drama of Air Products and Chemicals, Inc.'s attempt to takeover Airgas, Inc. through a hostile tender offer. *Airgas, Inc. v. Air Products and Chemicals, Inc.*, Civ. Action No. 5817-CC (Del. Chancery Court 2010) (discussed below).

13 *See, e.g.*, D. Katz and L. McIntosh, *Corporate Governance Update: Institutional Investors Ready Proxy Season 'Wish Lists,'* (November 2006).

14 *See, e.g.*, "Board Classification and Managerial Entrenchment: Evidence From the Market for Corporate Control" (April 2007).

15 *See Research Spotlight: All Newly Declassified Boards Are Not Created*, available at www.sharkrepellent.net (October 2004).

16 Please note: this number may be higher; in seven filings, it was not clear whether declassification would occur gradually or immediately.

17 Please note: this decision was overruled by the Delaware Supreme Court on November 23, 2010, on the grounds that the bylaw provision was inconsistent with the Airgas charter and the applicable statute. *Airgas, Inc. v. Air Products and Chemicals, Inc.*, 2010 WL 4734305 (Del. 2010).

The Dodd-Frank Act's Expansion of the SEC's Enforcement Powers

by Charles J. Ha and Newman A. Nahas[1]

The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Dodd-Frank Act") has been described as the most significant and wide-ranging financial reform act since the Great Depression. The primary focus of the Dodd-Frank Act is the reform of banking regulations, but the Dodd-Frank Act reaches far beyond just that industry. In particular, the Dodd-Frank Act makes wide-ranging changes to the SEC's ability to enforce its regulations and the federal securities laws.

As an initial matter, Section 991 of the Dodd-Frank Act nearly doubles the SEC's budget over the next five years from $1.3 billion in fiscal 2011 to $2.25 billion in 2015. Additionally, the Dodd-Frank Act creates a reserve fund for use by the SEC of up to $100 million that will be funded by registration fees collected by the SEC under the Securities Act and the Investment Company Act. The budget increase and reserve fund will likely bolster the SEC's enforcement activities and lead to a significant increase in SEC investigations, examinations and lawsuits.

In addition to increased funding, the Dodd-Frank Act also expands the SEC's ability to bring enforcement actions in a variety of different contexts—any one of which can have a significant impact on counsel's strategic decisions when representing clients in connection with an SEC investigation or litigation. While these changes are too numerous to cover in this article, we highlight below five significant changes to the SEC's enforcement powers of which counsel should be aware.

1. Aiding and Abetting Violations in SEC Actions

The Dodd-Frank Act expands the SEC's ability to bring enforcement actions for aiding and abetting violations of the securities laws in two respects. First, Sections 929M and 929N of the Dodd-Frank Act authorizing the SEC to now bring aiding and abetting claims under the Securities Act of 1933 ("Securities Act"), the Investment Company Act of 1940 ("Investment Company Act"), and the Investment Advisers Act of 1940 ("Investment Advisers Act"). Second, the Dodd-Frank Act makes it easier for the SEC to prevail on its aiding and abetting claims under the Exchange Act. Section 929-O of Act changes the mental state required for an aiding and abetting claim under Section 20(e) of the Exchange Act of 1934 (the "Exchange Act") from "knowingly" providing aid to a "reckless[ness]" standard. As a result of these changes, counsel should be aware that clients who are not directly alleged to have made misstatements or omis-

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The Dodd-Frank Act's Expansion of the SEC's Enforcement Powers *continued*

sions in registration statements and prospectuses may now face potential liability for aiding and abetting claims in SEC enforcement actions.

In addition to these changes, the Dodd-Frank Act signals the prospect of a major shift in aiding and abetting liability in private securities actions. Currently, private actions for aiding and abetting claims are barred, as set out in *Central Bank of Denver, N.A. v. Fist Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) and *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008). Section 929Z(a) of the Dodd-Frank Act, however, directs the Comptroller General to conduct a study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws. Such an expansion of aiding and abetting liability in the private civil context would significantly increase potential liability for auditors, lawyers and other secondary actors who have been protected against such claims in the past.

2. Whistleblower Provisions

Section 922 of the Dodd-Frank Act creates monetary incentives for whistleblowers to provide tips of fraud to the SEC by providing for a "bounty" of 10%-30% of a monetary recovery if their tip leads to an SEC enforcement action that results in sanctions of more than $1 million. To qualify for a bounty, the whistleblower must provide the SEC with information that it did not already know from another source. Section 922 also provides that the whistleblower can submit anonymous tips and need not identify themselves until the government pays the bounty.

While it is obviously still too early to determine what actual effect this bounty will have on the provision of confidential tips, it may well result in a significant increase in the number of "confidential witnesses" who provide information to the SEC in connection with potential securities fraud. This may result in an increase in the number of enforcement actions by the SEC and in an increase in the quality of information available to the SEC at the early stages of its investigations.

3. Jurisdiction Over Foreign Securities Transactions

Earlier this year, the Supreme Court in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 177 L. Ed. 2d 535 (2010), held that the antifraud provisions of U.S. securities laws do not apply to foreign plaintiffs suing foreign defendants for fraud in connection with securities transactions on foreign exchanges. Section 929 of the Dodd-Frank Act, overturns the *Morrison* decision with respect to enforcement actions brought by the SEC. Section 929 of Act empowers the SEC to reach foreign securities transactions so long as the matter involved either: (1) conduct within the United States that constitutes significant steps in furtherance of the violation, or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States. Thus, counsel should be aware that, while *Morrison* still applies to private civil litigation involving foreign transactions, the protection afforded by that decision will not apply in SEC enforcement actions.

4. Penalties in Administrative Proceedings

Section 929P(a) of the Dodd-Frank Act empowers the SEC to seek penalties in administrative proceedings under the Securities Act, the Exchange Act, the Investment Company Act and the Investment Advisers Act. Previously, the only way for the SEC to impose penalties was to file a lawsuit. In the wake of the Dodd-Frank Act, therefore, we expect the SEC to bring more of its cases as administrative proceedings. This is a significant development, as individuals and companies involved in administrative proceedings with the SEC will have more limited rights to pretrial discovery, less protective evidentiary rules, no right to a jury trial, and the only administrative "appeal" to which they will have recourse is to the SEC commissioners themselves, who originally voted to bring the administrative action.

5. New Clawback of Executive Incentive-Based Compensation

Section 954 of the Dodd-Frank Act requires that publicly traded companies develop and implement (i) a policy for the disclosure of incentive-based compensation "that is based on financial information required to be reported under the securities laws," and (ii) a policy for the recovery of incentive-based compensation from current and former executive officers in the event of an accounting restatement due to material noncompliance of the issuer with any financial reporting requirement under the securities laws.

Notably, the operation of Section 954 of Dodd-Frank is independent of and broader than the clawback provisions contained in Section 304 of the Sarbanes-Oxley Act ("SOX"). While the reach of Section 304 of SOX is limited to the incentive compensation of a chief executive officer or chief financial officer during the one year preceding the misstated financial filing, Section 954 of Dodd-Frank reaches the incentive compensation of ***all*** current and former executive officers during the three years preceding the misstated financial filing. Additionally, while the clawback provision of Section 304 of SOX requires "misconduct," Section 954 of Dodd-Frank is triggered by "material noncompliance … with any financial reporting requirement under the securities laws." Section 954 of Dodd-Frank is, however, limited to the recovery of incentive compensation "in excess of what would have been paid to the executive officer under the accounting restatement."

Counsel representing individual company executive defendants in litigation involving accounting restatement should therefore be cognizant of the increased potential liability that their clients may now face in light of these new provisions.

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The Dodd-Frank Act's Expansion of the SEC's Enforcement Powers *continued*

As noted above, the Dodd-Frank Act in an enormously wide-ranging and complex law that contains a host of other changes to securities regulation and enforcement powers. These range from the ability to issue nationwide trial subpoenas in civil actions under Section 929E to the imposition of fiduciary duties on brokers and dealers under certain circumstances under Section 913. While it is beyond the scope of this article to discuss each of these changes, counsel who represent clients in matters where the SEC is likely to become involved should familiarize themselves with the changes that the Dodd-Frank Act has made to the SEC's powers as such changes may well impact counsel's strategic decisions regarding potential enforcement actions.

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- Register for a CLE seminar.
- Shop at the WSBA store (order CLE recorded seminars, deskbooks, *Resources*, etc.).
- Access Casemaker free legal research.
- Sign up to volunteer for the Home Foreclosure Legal Assistance Project or the Moderate Means Program.

WAACO Update

Nonprofit organizations throughout Washington state provide crucial services for the neediest of our citizens, and improve our communities so that we can all enjoy a healthy and diverse society. These organizations are often run on a shoestring by dedicated volunteers deeply committed to the organization's charitable mission, but without experience with or knowledge of the corporate, intellectual property, tax, real estate, contract, employment, and other legal issues that, like all businesses, their organizations face.

Since 2004, Washington Attorneys Assisting Community Organizations (WAACO) has provided the vital link between nonprofits that need legal assistance but cannot afford it, and generous Washington business and transactional lawyers who are eager to donate their time and expertise to strengthen the capacity of these nonprofits and the communities they serve. Nonprofits are now especially feeling the downturn in the economy, and, more than ever, are seeking sound legal advice that can help them keep their doors open and their programs active.

Since WAACO was launched in 2004, 234 attorneys have volunteered for our pro bono panel. These volunteer lawyers have reported donating over 5,000 hours assisting over 240 nonprofit organizations in over 190 distinct business legal matters. The volunteer attorneys' time, experience, and compassionate professionalism have brought welcome results to the nonprofits they have served. Our business lawyers have, for example:

- Advised an organization that provides emergency shelter and services to homeless youth on corporate restructuring;
- Helped an organization that works to expand cancer screening into underserved communities to incorporate and successfully apply for 501(c)(3) status;
- Revised bylaws for an organization that advocates for arts programming in public schools;
- Helped an organization that provides entrepreneurial training to low-income youth to develop program agreements;
- Assisted an organization that provides education, treatment, and counseling around youth drug and alcohol abuse in registering a new name, and advised it on revenue-generating activities;
- Advised a food bank on changing its corporate structure;
- Drafted an employment manual for an organization that sponsors farmers markets.

WAACO receives over 200 inquiries per year from organizations seeking pro bono legal assistance. WAACO carefully

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WAACO Update continued

screens each applicant to assure that each organization referred to the pro bono panel (1) is, or is trying to become, a tax-exempt nonprofit organization, (2) has a non-litigation-related matter, and (3) is unable to pay for legal services without significant impairment of program resources.

WAACO also works hard to assure that its volunteer panel is up-to-date on issues that uniquely affect nonprofit organizations. It sponsors an annual CLE on the "Nuts and Bolts of Representing Nonprofit Organizations." This half-day seminar walks participants through the process of incorporating as a nonprofit organization in Washington state and applying for 501(c)(3) status with the IRS, and provides an overview on nonprofit compliance issues. WAACO has also launched a series of lunchtime issue-specific CLEs. In the last year, the topics covered fiscal sponsorship, employment issues and website issues. WAACO's website *www.waaco.org* contains up-to-date information on these educational seminars and other resources concerning nonprofit legal issues.

WAACO created a legal self-assessment checklist for nonprofits to help organizations self-identify legal issues. The checklist has been widely distributed in the nonprofit community, has been highly praised by the community, and has resulted in more organizations seeking legal assistance. One nonprofit consultant wrote that the checklist is "a 'must read' for ALL smaller or newer not-for-profits and a good reminder for even well-developed organizations." In conjunction with the King County Bar Association, WAACO recently published an update to the 2001 KCBA publication "How to Form and Maintain a Nonprofit Corporation in Washington State." This handbook, authored by Washington business and nonprofit attorneys, provides valuable guidance to nonprofit managers and services providers on the legal issues typically faced by nonprofit organizations. It is available in pdf form on WAACO's website (www.waaco.org), and serves as a valuable tool for both the legal and nonprofit communities.

In October 2008, WAACO began providing business legal assistance to low-income microentrepreneurs. WAACO volunteers staff a monthly clinic at the offices of Washington Community Alliance for Self-Help (CASH) ("Washington CASH"), a south Seattle nonprofit organization that provides microloans, training and support to low-income entrepreneurs. The business attorneys participating in this clinic have provided guidance to the low-income microentrepreneurs on a variety of legal topics, including choice of entity and formation questions; license agreements; non-compete agreements; employment (how to hire and classify workers); contracts with vendors; trademarks; and tax matters. Through this legal clinic, we have begun to refer matters to attorneys for more substantial transactional pro bono work through WAACO's Extended Legal Services program.

WAACO itself is a 501(c)(3) organization that relies on donations from the legal and business community. It is grateful for the financial support the WSBA Business Law Section has provided since its founding.

If you would like to receive notices of WAACO pro bono opportunities or notices of our CLEs, or if you have any questions regarding how you can participate, please email *contact@waaco.org*.

Business Law Section

The officers and Executive Committee of the Business Law Section urge you to become an active member of this important section. Educational programs and current newsletter reports on the law are part of the many benefits available to Section members. All members of the WSBA are eligible. Join today.

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