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Some Thoughts for Boards of Directors

The attached paper reflects advice I have been giving to directors and boards concerned about a growing overemphasis on process as a result of the post-Enron reforms embodied in Sarbanes-Oxley, new SEC regulations and new stock exchange rules. Compliance with the new regulations and rules is not that difficult. Process should not, and need not, overwhelm attention to the business of the company, and the new regulations and rules should not, and need not, deter the CEO and the directors from pursuing entrepreneurial opportunities. The business judgment rule is alive and well. The primary focus should be on performance of the business and maximizing shareholder value, not on process.

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The post-Enron accounting and corporate governance reforms have imposed new responsibilities on corporate directors. At the same time, there is a continuing drumbeat of demands for limitations on director authority from activist shareholder groups, populist politicians and academic gadflies. Chief among the demands are a more stringent definition of director independence, more "shareholder power" and more restrictions on the amounts and form of executive compensation. These demands were backed up by 1100 shareholder proxy proposals in 2003, of which 172 were approved.

The response of accounting, consulting and legal advisors has been an almost endless parade of best practices, stylized agendas, checklists, director education programs and extra meetings. Some of these will undoubtedly contribute to improved governance and transparency. But the totality, unless judiciously applied, is more likely to make boards less, rather than more, effective, and in extreme cases will so overburden boards with process that they become dysfunctional. There is no legal reason for directors to be overly concerned about process. The business judgment rule is alive and well. It is not necessary for boards to overreact in order to establish entitlement to the protection of the rule.

In order to avoid an overemphasis on process and at the same time effectively discharge the board's fundamental duties to appropriately monitor and supervise the business of the corporation, it is necessary to identify the matters on which the board should focus and to create a reasonable program to deal with them. The following are recommendations for such a program in today's environment. Obviously, "one size does not fit all" and the board of each corporation can and should tailor procedures to its own circumstances. This memo assumes that the corporation has implemented all of the Sarbanes-Oxley, SEC and NYSE post-Enron reforms and this is not an "how to do it" memo about complying with those requirements.

Tone at the top. One of the single most important factors in ensuring that a board meets all of its duties is that there is the right "tone at the top" of the corporation. If the CEO and senior management are not personally committed to high ethical standards, full compliance with legal requirements and fair dealing, no amount of board process or corporate compliance programs will ensure that the board avoids embarrassment. The board should periodically review with the CEO what the CEO is doing to set the right example and how it is being communicated to all employees and constituents of the corporation. The board's vision for the corporation, including its commitment to ethics and compliance, should be set out in the annual report.

CEO selection and succession planning. The single most important function of the board is selecting and evaluating the CEO and the senior executive leadership of the corporation and planning for their succession. There are no prescribed procedures for doing this and a board should fashion what it deems appropriate. The NYSE requirement for periodic executive sessions of the board is intended to facilitate CEO evaluation and selection. In fulfilling its CEO selection and succession function, the board should recognize that by itself competence is not

enough. The integrity and dedication of the CEO is critical in enabling a board to meet all of its duties. In large measure the fate of each of the board and the CEO is in the hands of the other.

Independence. There is currently an overemphasis on board independence to the detriment of promoting the sort of board dynamic that can most effectively lead to a well-functioning board and an effective board partnership with senior management to the benefit of the corporation and its shareholders. The NYSE, after thoughtful consideration, decided to require only that a majority of the board be independent. Nevertheless many of the shareholder advisory services, institutional investors and academic gadflies are continuing to urge (in some cases, demand) that all directors other than the CEO be independent and that social and philanthropic ties among and between the directors and the CEO be considered as impugning, if not destroying, independence. The Breeden Report, which imposed new governance rules on MCI, goes so far as to prescribe rigid requirements for all director nominees and to mandate rotation of one director each year. The 2004 ISS Corporate Governance Policy defines independence as "no connection to the company other than a board seat." These types of requirements and restrictions are the antithesis of the kind of collegiality and relationship with the CEO that is necessary for the board and CEO together to promote the appropriate tone at the top, to agree on the corporate mission and work collectively to enhance the corporation's business. The concept of the board as remote strangers and as the agency for the discipline of management, rather than as partner with management in setting the strategic course of the corporation, is contrary to all prior experience and will not lead to better performance. The tension between the new norms of independence and the overarching objective of better performance, unless modulated and maintained in perspective, can cause the former to overwhelm the latter.

Monitoring performance. While the corporation laws literally say that the business of the corporation is to be managed by the board of directors, it is clear that the board's function is not to actually manage, but to ensure that the corporation is effectively managed by monitoring the performance of the CEO and senior officers. To meet its duty to monitor performance, the board and management together need to determine the information the board should receive. Here "more can be less." The board should not be overloaded with information. It is not necessary that the board receive all the information that the CEO and senior management receive. The board should receive financial information and ratios that enable it to readily understand results of operations, variations from budget and trends in the business, the corporation's performance relative to peers, and any other information that the board determines to be useful in its work. The board should receive copies of all security analysts' reports, press articles and other media reports on the corporation. If an article or report raises performance or other issues, the board should make sure it receives a satisfactory explanation of the issues raised in the publication including, if appropriate, of what is being done to correct the situation. By tracking these reports and articles, the board will avoid the possibility of being accused of ignoring problems that were known to others and which could have been known by the directors.

Monitoring compliance. As with performance, the board has a duty to monitor legal and regulatory compliance by the corporation. The board does not have a duty to ferret out compliance problems. It does, however, have a duty to take appropriate action when it is aware of a problem and management is not properly dealing with it. In normal situations it is sufficient for the board to review compliance matters and litigation semi-annually. This may be done directly by the board or through the audit committee. However it is done, it is a desirable practice

for the board or the committee to have executive sessions with the general counsel of the corporation. Where there is a serious investigation or litigation that is being handled by outside counsel, direct reports by such counsel to the board or committee are desirable. In addition the board should annually receive a report as to the corporation's compliance programs and the views of the general counsel as to their adequacy.

The Enron directors have been criticized for not adequately performing their monitoring duties. The legal community, including prominent judges, have stated that Enron's short meetings are evidence of failure by the directors to fulfill their fiduciary duties. Some have suggested that a board's failure to allot adequate time to carry out its duties could call into question whether it had acted in good faith. In addition to scheduling regular board and committee meetings to provide ample time for the regular business of the board, boards should consider the desirability of an annual two-to-three-day board retreat with the senior executives at which there is a full review of the corporation's financial statements and disclosure policies, strategy and long-range plans, and current developments in corporate governance. Each retreat may be held at a location close to one of the corporation's operations so as to give the directors an opportunity to become acquainted with a number of the corporation's operations as the annual retreats are rotated among the corporation's various locations. During the retreat, meals and social activities may be arranged in a manner that encourages the directors to get to know the senior executives on a one-on-one basis. Corporations should also provide comprehensive orientation for new directors so as to acquaint them with the corporation's strategy, long-range plans, financial statements, properties and operations, corporate governance guidelines and senior executives. The annual retreat could satisfy a major portion of such an orientation.

Corporate strategy. Approval of the corporation's long-term strategy is a key board function. Strategy should be formulated initially by management and then developed finally by an interactive process with the board. Many companies find that as part of the strategy development process an annual strategy review that is part of a board retreat of the type referred to above is productive.

Crisis management. Perhaps the most important test of a board comes in times of crisis. Boards need to be proactive in taking the reins in the context of any governance, compliance or business crisis affecting the corporation. At the same time, boards need to be cautious not to overreact to any given situation and thereby create a crisis. There is a mixed record regarding how well boards have been handling recent crises. It appears that many boards have functioned quite well in taking a careful measure of the situation and putting in place the right procedures for obtaining the necessary information about the issues facing the corporation and developing the right strategies for responding to the situation and rectifying any management, disclosure or legal/compliance deficiencies. Others, however, appear to have either overreacted, or to have placed matters in the hands of lawyers, accountants and other outside experts, and thereby lost control of the situation to those outsiders. And, in some instances the crises themselves appear to have arisen in large part from the failure of management and the board to be proactive in reacting to earlier warning signs.

All crises are different and it is difficult to give generic advice that will be relevant to any particular crisis without knowing the facts involved. That said, in most instances when a crisis arises, the directors are best advised to manage through that crisis as a collegial

body working in unison. While outside advisors (counsel, auditors, consultants and bankers) can play a very useful and often critical role in getting at all of the relevant facts of a given situation and in helping to shape the right result, the directors should maintain control and not cede the job of crisis management to the outside advisors. And, while there is often the impulse to resign from the board upon the discovery of a crisis, in most instances, directors are best served by staying on the board until the crisis has been fully vetted and brought under control.

Major transactions. Board consideration of major transactions, such as acquisitions, mergers, spinoffs, investments and financings, needs to be carefully structured so that the board receives the information necessary in order to make a reasoned decision. This does not mean that outside advisors are necessary, even for a very large transaction. If the corporation has the internal expertise to analyze the requisite data and present it in a manner that enables the board to consider the alternatives and assess the risks and rewards, the board is fully justified in relying on the management presentation without the advice of outside experts. There is no need for the board to create a special committee to deal with a major transaction, even a hostile takeover, and experience shows that a major transaction is best addressed by the full board. Management should build a strong foundation to support a major transaction, including an appropriate due diligence investigation. The board should have ample time to consider a major transaction, including in cases of complicated transactions and agreements a two-step process with the actual approval coming only after an initial presentation and the board having had time for reflection.

Related party transactions. There is nothing inherently improper about transactions between a corporation and its officers or directors; such transactions are often in the best interests of a corporation and its shareholders, offering efficiencies and other benefits that might not otherwise be available. It is entirely appropriate for an informed board, on a proper record, to approve such arrangements through its disinterested directors. As a matter of compliance and best practices, however, and particularly in the current governance and disclosure environment, the corporation should give careful attention to review and disclosure of all "related party" transactions. Full disclosure of all material related party transactions and full compliance with proxy, periodic reporting and financial footnote disclosure requirements is essential. Management should make sure that all related party transactions have been fully and carefully reviewed with the board. The board should reevaluate the corporation's policies and procedures for reviewing such transactions on both an initial and ongoing basis and for ensuring that all continuing related party transactions remain in the best interest of the corporation. The board should consider assigning to a committee consisting solely of directors who are both independent and disinterested with respect to the transaction under consideration (*e.g.*, the audit or governance committee) the job of reviewing any newly proposed related party transactions. The committee should have the authority to hire such outside financial, legal and other advisors as it deems appropriate to assist it in its evaluation of such transactions. If a related party arrangement is of material significance to the corporation (either due to the nature of the service provided or by virtue of the identity of the related party), the board should consider whether additional steps are necessary to ensure that such transactions are properly monitored and evaluated. For example, the board should take active measures to ensure that the entities providing related party services are being held to the same standards the corporation would demand of unaffiliated third party service providers and that there is a clear reason for procuring the service from a related party.

Confidentiality and the role of directors outside the boardroom. A board should function as a collegial body, and directors should respect the confidentiality of all discussions that take place in the boardroom. Confidentiality is essential for an effective board process and for the protection of the corporation and its stockholders. Moreover, directors generally owe a broad legal duty of confidentiality to the corporation with respect to information they learn about the corporation in the course of their duties. Maintaining confidentiality is also essential for the protection of the individual directors, since directors can be responsible for any misleading statements that are attributable to them. Even when a director believes the subject matter of his or her statements is within the public domain, it is good practice for individual directors to avoid commenting on matters concerning the corporation. A director who receives an inquiry with respect to the corporation from outside the corporation may or may not have all of the relevant information and his or her response could involve the corporation, as well as the director, in a disclosure violation. Directors should also respect the role of the CEO as the chief spokesperson for the corporation. They should generally not engage in discussions with outsiders concerning corporate business unless specifically requested to do so by the CEO or the board. Where it is necessary for outside directors to speak on behalf of themselves or the corporation, here too it is best for one member of the board to be designated as the board's spokesperson. Where a board has a non-executive chairman or a lead director, under certain circumstances it may also be appropriate for the chairman or lead director to speak on behalf of the corporation, particularly within the ambit of those directors' special roles. In the ordinary course, all such matters should be handled in close consultation with the CEO so as to avoid confusion in the corporation's public statements and posture.

Board, committee and CEO evaluations. The NYSE requires annual evaluations. Many consulting firms have published their recommended forms and procedures for conducting these evaluations. Consultants have also established an advisory service in which they meet with the board and committee members to lead them through the evaluation process. Each board needs to decide how to conduct its evaluation. In making the decision, it should be noted that it is not required that the board receive outside assistance and it is not required that multiple-choice questionnaires and/or essays be the means of evaluation. If a board prefers to do the evaluation by discussion at meetings, that is acceptable. It should also be noted that documents and minutes created as part of the evaluation process are not privileged and care should be taken to not create ambiguous records that may be used in litigation against the corporation and the board.

Executive compensation. This is today's most high profile corporate issue. Everyone who has weighed in on this issue agrees that executive compensation should be aligned with long-term performance of the corporation and shareholder value. That said, there is a wide spectrum of views as to how to achieve the agreed objective. The only really useful advice is thoughtful process, full disclosure and recognition by the compensation committee that it should not be deterred by the current criticism of the level of executive compensation from doing what it feels is in the best interests of the corporation.

Charters, codes, guidelines and checklists. The audit, compensation and nominating-governance committees are required to have charters. The corporation is required to have a code of ethics. The board is required to have corporate governance guidelines and, as noted, there is no end to the number of recommended checklists designed to assist corporations in complying with Sarbanes-Oxley, SEC regulations and NYSE rules. All of these are to some extent

useful in assisting the board and committees in performing their functions and in monitoring compliance. However, there is a tendency to expand the scope of charters and checklists to the point that they are counterproductive. If a charter or checklist requires review or other action and the board or committee has not taken that action, the failure can be considered evidence of lack of due care. The creation of charters and checklists is an art that requires experience and careful thought. It is a mistake to copy the published models. Each corporation should tailor its own charters and checklists, limiting them to what is truly necessary and what is feasible to accomplish in actual practice. In order to be "state of the art" it is not necessary that the corporation have everything someone else has. Charters and checklists should be carefully reviewed each year to prune unnecessary items and to add only those items that will in fact help directors in discharging their duties.

The audit committee. The post-Enron reforms have invested the audit committee with a special role in corporate governance. In large measure, the audit committee has become the principal means by which the board discharges its duty to monitor financial and disclosure compliance. Accordingly, boards should carefully select audit committee members and, to the greatest extent possible, be attuned to the quality of the audit committee's performance. In view of the audit committee's centrality to the board's duties of financial review, it is also important for the board as a whole to receive periodic reports from the audit committee and to be comfortable that the audit committee, the auditors and management are satisfied that the financial position and results of operations of the corporation are fairly presented.

Shareholder relations. One of the most significant products of the Enron-type scandals is the increase in shareholder-sponsored proxy resolutions and withhold-the-vote campaigns. In addition, the SEC has adopted a new rule with respect to disclosure of the director nominating process and is considering adopting a shareholder access rule that would enable shareholders to directly nominate a director through the corporation's own proxy. The board should regularly review the corporation's shareholder relations programs and consider whether it is appropriate for the board to have greater interaction with shareholders. Where the corporation has performance or compliance issues, direct board contact with shareholders may forestall a proxy initiative by shareholders. In addition, the corporation should weigh carefully opposition to shareholder proxy resolutions that can be accommodated without significant difficulty. Today it is prudent to do a risk-reward analysis of shareholder resolutions, rather than to routinely oppose them.

Directors' duties and responsibilities. The basic responsibility of directors is to exercise their business judgment to act in a manner they reasonably believe to be in the best interests of the corporation and its shareholders. In discharging these obligations, directors are entitled to rely on management and the advice of the corporation's outside advisors. The board should make sure that the corporation's legal counsel, both internal and external, and auditors, both internal and external, know that they have direct access to the board, if ever needed.

Directors are not guarantors that nothing will go wrong on their watch. Directors are monitors and gatekeepers charged with the duty of installing competent managers and selecting competent advisors who they reasonably believe will serve the best interests of the corporation and diligently monitoring their conduct. They should inquire with due care to make sure that the corporation is operating in compliance with applicable laws and regulations, insist that

management take the requisite responsibility for ensuring the accuracy and completeness of the corporation's financial statements and public disclosures and that management take all necessary corrective actions when compliance failures or deficiencies are noted. The courts continue to respect the directors' entitlement to rely on senior management's performance of their obligation to ensure the accuracy of information disseminated by the company.

Directors are expected to attend board meetings on a regular basis, as well as the meetings of the committees on which they serve, and to spend the time that is needed to properly discharge their functions. Directors should make sure that they are receiving from management and from the corporation's auditors and outside advisors all of the information and data they deem relevant to understanding the issues before them and reaching sound business judgments with respect thereto. Perhaps the clearest lesson so far from the accounting and compliance cases making headlines today is that, too often, boards did not have clear information as to what was going on.

When complex legal, governance or accounting issues arise it will be useful for a director to ask the following simple questions:

- Have I acted with undivided loyalty to the corporation and its shareholders and have all my personal interests in this matter been fully disclosed?
- Have I exercised due care in examining the issues underlying the proposed action, including receiving advice as to whether the action is in compliance with applicable rules and regulations?
- Will the proposed action and the relevant facts and circumstance be candidly disclosed to all effected parties?

If the answers to those questions are yes, a director will be fully protected in exercising his or her business judgment and, even if, with the benefit of hindsight, the judgments prove flawed, the director will not be faulted.

In the words of Norman Veasey, Chief Justice of Delaware:

> Although the law of fiduciary duty recognizes the evolving expectations of the standards of conduct of directors and officers, we must keep in mind that the business judgment rule continues unabated to protect directors' decisions made in good faith and to enable them to set strategic goals for prudent risk-taking. What has evolved in this new era is a sharper judicial focus on the *processes* employed by directors, but it is not a regulatory clamp on their business judgment.