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Some Thoughts For Boards of Directors in 2005

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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 more than 1100 shareholder proxy proposals in 2004, of which over 130 received majority shareholder votes. Increasingly, the pressures on today's directors are coming from a multitude of directions, with federal securities laws, federal sentencing guidelines, stock exchange governance requirements, shareholder activism and court decisions all competing to mandate or suggest new director responsibilities.

The decisions by the non-management directors of WorldCom and Enron to pay out of their own pockets $18 million and $13 million, respectively, to settle shareholder lawsuits has significantly increased the concerns of directors as to their exposure to liability. Although both WorldCom and Enron were extreme cases and neither involved any judicial determination of fault by the directors, the harsh language used by the lawyers representing the shareholder-plaintiffs and by Alan Hevesi, the Comptroller of the State of New York and the lead plaintiff in the WorldCom case, that the settlement "sends a strong message to the directors…that they must be vigilant guardians for the shareholders…[and] [w]e will hold them personally liable if they allow management…to commit fraud" has put additional pressure on directors.

The response to these pressures by the accounting, consulting and legal advisors to corporations 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.

Despite the WorldCom and Enron settlements, there is no legal reason for directors to be overly concerned about process. These two cases are among the most egregious of the series of scandals that followed the bursting of the Millennium Bubble, were the subject of scathing reports by the bankruptcy trustees critical of the directors, involved billions in fraudulent misstatements, and were brought under the strict liability provisions of the Federal Securities Laws, not the fiduciary duty requirements of state law. They do not establish a precedent for the future. 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 and freedom

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from the threat of personal liability. It is still safe to sit on the board of a public company in the U.S.

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.

The role and duties of the board. The past twenty years have witnessed a transition from the advisory board to the monitoring board. While the board has always had a dual role as a resource and adviser for management, on the one hand, and as an independent agent of shareholders on the other, in recent years government regulators and activist shareholders, empowered by the reaction to the Enron-type scandals and often in competition with each other, have been tipping this balance with increasing force in favor of monitoring. But even today it is generally acknowledged that a combination of the two is necessary and that only a collegial board can function effectively. To be truly effective, each board must find the right balance between monitoring and advising as to strategy.

Tone at the top. One of the single most important factors in ensuring that a board meets all of its duties is having the right "tone at the top" of the corporation. The tone at the top will form the culture of the corporation and permeate the corporation's relationship not only with investors, but also with employees, customers, suppliers, local communities and other constituents. If the CEO and senior management are not personally committed to high ethical standards, principles of fair dealing, full compliance with legal requirements and resistance to Wall Street pressures for short term results, no amount of board process or corporate compliance programs will protect the board from embarrassment. The board should participate in creating the corporate culture and should periodically review with the CEO what the CEO and senior management are doing to set the right example and how it is being communicated to all employees and constituents of the corporation. Transparency is key: the board's vision for the corporation, including its commitment to ethics and zero tolerance to compliance failures, should be set out in the annual report and communicated effectively within the corporation.

CEO selection and succession planning. In addition to setting the tone at the top, 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. The critical importance of the CEO role is a function of the modern corporation itself. As Peter Drucker recently put it, "the Enterprise can be said to be the one invention that created the Modern Economy – far more so than any other invention, whether material or conceptual. With the invention of the Enterprise the Executive came into being as a distinct role and function, with one of his or her major tasks being the making of the decision between short-term yields and deferred expectations." As the central interface between the corporation and what stands outside it, e.g., society, the economy, technology, markets, customers and the media, the CEO plays the key role in the modern corporation.

There are no prescribed procedures for planning succession and selecting the CEO and a board should fashion the principles and procedures it deems appropriate. 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 an overemphasis on board independence that risks losing sight of the importance of promoting the sort of board dynamic that can most effectively lead to a well-functioning board and an effective partnership between the board and senior management. The NYSE, after thoughtful consideration, decided to require only that a majority of the board be independent. Today, most boards have only one or two directors that are not independent: the CEO and maybe one other current or former officer. 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. 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. What companies need are directors who possess sufficient character and integrity to allow them to make judgments unaffected by considerations affecting themselves or those with whom they have relations. 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.

As a general rule, companies should be careful in the current environment to make full and complete disclosure of any relationships or transactions that could be deemed to affect the independence of a director. Many relationships that may have been considered commonplace in the past (such as a director's involvement with a nonprofit organization that is heavily supported by the company) may, in today's skeptical environment, cast doubt on the level of that director's independence when viewed with hindsight after a crisis has arisen. This is not to say that all such relationships should be prohibited, but rather that all should be considered in assessing a director's independence.

Executive compensation. This is today's most high-profile corporate issue and a major focus of shareholder activism. Virtually 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. In addition, most companies, including well-performing ones, need to engage in recruiting and retention efforts to attract, and prevent the loss of, qualified individuals serving as key employees. That said, there is a wide spectrum of views as to how to achieve the agreed objectives. The only really useful advice is thoughtful process, full disclosure and recognition by the compensation committee that it should not be deterred by the focus on levels of executive compensation from doing what it feels is in the best interests of the corporation. Executive compensation should directly link the interests of senior management and the long-

term interests of shareholders. Some organizations, such as the Business Roundtable, have recommended the use of performance thresholds to achieve this. In order to ensure that compensation and severance packages are justifiable, members of the compensation committee should fully understand all the costs and benefits of the compensation arrangements that they are considering. Particular attention should be paid to severance arrangements and to all benefits provided to senior management in connection with termination of employment. Perquisites should be kept reasonable and a line should be drawn between business and personal expenses. Both the Business Roundtable and the Blue Ribbon Commission on Executive Compensation of the National Association of Corporate Directors have also emphasized the importance of transparency and full disclosure of compensation packages.

Director Compensation. Director compensation is one of the more difficult issues on the corporate governance agenda. On the one hand, more is being expected of directors today in terms of time commitment, responsibility and exposure to public scrutiny and potential liability. On the other hand, the higher the director's pay, the greater the chance it will raise an issue of independence. The compensation committee should determine the form and amount of director compensation with appropriate benchmarking against peer companies. It is legal and appropriate for basic directors' fees to be supplemented by additional amounts to chairs of committees and to members of committees that meet more frequently or for longer periods of time.

While there has been a current trend, encouraged by institutional shareholders, to establish stock-based compensation programs for directors, the form of such programs should be carefully considered to ensure that they do not create the wrong types of incentives for directors. In the current environment, restricted stock grants, for example, may be preferable to option grants, since stock grants will align director and shareholder interests more directly and avoid the perception that option grants may encourage directors to support more aggressive risk taking on the part of management to maximize option values. Perquisite programs and company charitable donations to organizations with which a director is affiliated should also be carefully scrutinized to make sure that they do not jeopardize a director's independence or create any potential appearance of impropriety. Where appropriate, such perquisites should be fully disclosed.

Nomination of director candidates. Under the existing corporate governance system, a company's nominating committee nominates candidates for membership on the company's board. Shareholders can propose potential director candidates to the company's nominating committee, which under the NYSE rules must be composed entirely of independent directors. The nominating committee has a duty to consider *bona fide* candidates and to nominate directors that it believes will best serve the interests of the company and its shareholders. In evaluating potential director candidates, whether they are proposed by management or shareholders, the nominating committee should use the same fundamental criteria. The foremost criterion is competence: boards should consist of well-qualified men and women with appropriate business and industry experience. The second important consideration is collegiality. A balkanized board is a dysfunctional board; a company's board works best when it works as a unified whole, without camps or factions and without internal divisions. The nominating committee should also try to ensure that the board consists of individuals who understand and are willing to shoulder the time commitment necessary for the board to effectively fulfill its responsibility to advise and monitor management. To this end, companies

should consider including in their corporate governance guidelines policies limiting the number of boards on which a director may sit. Those guidelines should also address director tenure. Companies should consider whether it would be advisable for them to impose term and age limits on directors. There is no formula for the perfect board. Strong, independent directors are essential to proper board functioning, but so too are elusive qualities such as collegiality, sense of common purpose, energy, industry knowledge, business sense and trust. Each company, through its independent nominating committee, must have the flexibility to determine the mix of qualifications and attributes that is best suited to the specific needs of the corporation.

Monitoring performance. While the corporation laws literally say that the business of the corporation is to be managed by or under the direction of 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 that enables 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 significant security analysts' reports, press articles and other media reports on the corporation. If an article or report raises compliance, performance or other issues, the board should make sure it receives a satisfactory explanation of the issues raised in the publication, including, if appropriate, 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 audit 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 the audit committee are desirable. In addition the board should oversee an annual review of the corporation's compliance programs and its information and reporting systems and receive an opinion of the general counsel as to their adequacy.

In performing its monitoring function, the board should be sensitive to "red flags" and "yellow flags". When such flags are raised, the board should observe and investigate as appropriate and document its monitoring activities in minutes that accurately convey the time and effort directors devote to decisionmaking, even when the outcome is to take no action. In a few recent cases (*Disney*, *Abbott* and *Caremark*), influential courts have indicated that directors may be held liable for lack of good faith in situations where they utterly fail, in "ostrich-like" fashion, to exercise *any* oversight. However, none of these cases contemplate director liability

where directors are using common sense and appropriate diligence in performing their oversight function. Directors remain fully protected by the business judgment rule when they make corporate decisions with the exercise of due care.

The federal sentencing guidelines also promote comprehensive compliance procedures and careful monitoring by requiring that directors be knowledgeable about compliance programs, be informed by those with day-to-day responsibility over compliance and participate in compliance training. The guidelines also provide that an effective compliance program monitored by the board may be a mitigating factor in a prosecutor's decision whether or not to charge a company with wrongdoing.

Review of controls and risk management. The board should also – whether directly, or through the audit committee – make sure that management has adopted and implemented proper risk assessment and management policies and procedures. The risks that a company might face include business risks (such as risks posed by defective products, violation of environmental requirements, accidents and political changes), financial risks (such as risks posed by financial asset composition, derivative securities, structured financing contingencies and guarantees), legal risks and reputation risks. The board should ensure that each category of risk is adequately addressed by the company's risk management procedures.

It is an important responsibility of management, and a key monitoring role for the board, to establish and maintain an adequate internal control structure and procedures for financial reporting and compliance with law, including applicable SEC disclosure requirements. The SEC rules implementing Section 404 of the Sarbanes-Oxley Act require management to prepare reports on internal controls and the independent auditor to attest to those reports as part of its audit, to be included in a company's annual report. The rules also call for a quarterly evaluation by management of a company's internal controls and procedures for financial reporting. Especially in the current environment, directors should pay careful attention to whether management has invested sufficient resources and energies in the company's control and risk monitoring and management infrastructure. The board should satisfy itself (by getting regular reports from the management and the internal auditor) that the company's existing internal control systems provide for the maintenance of financial records in a way that permits preparation of financial statements in accordance with GAAP and gives "reasonable assurance" of accuracy in financial reports, and that management designs and supervises processes that adequately identify, address and control compliance risks. That said, it should be borne in mind that while "reasonable assurance" is a high standard, it is not an absolute, and boards should avoid overreaction to the discovery of deficiencies.

Effectiveness of the board. 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, budget, the company's mission,

succession planning 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. In addition to orientation, corporation's should consider education programs for continuing directors, both to enhance their skills as directors as well as to educate them on current regulatory and corporate governance developments.

Committees of the board. The NYSE requires a listed company to have an audit committee, a compensation committee and a nominating/governance committee, each comprised solely of independent directors. The requirement that a committee be composed of only independent directors does not mean that the CEO (and other employees) should be excluded from all the discussions or work of the committee. Indeed, it would be virtually impossible for the committee to function effectively without the participation of the CEO. All compensation matters, including the CEO's compensation, should be discussed with the CEO, and all governance and director nomination matters should be discussed with the CEO. The final determination is that of the committee. While the committees have the authority to retain consultants, there is no requirement that the compensation committee retain a compensation consultant or that the nominating/governance committee retain a search firm, if the committee believes that it does not need the assistance of a consultant.

All companies, as part of their broader governance reviews, should carefully consider which directors satisfy the requirements for independence. Questionnaires should be used to determine and document both independence and qualification for committee assignments. In addition to these core committees, boards may wish to establish a variety of additional standing committees to meet their ongoing governance needs, such as a risk management committee (if this function is not being performed by the audit committee), a compliance committee, or a committee on social responsibility. Boards also use special committees from time to time either to deal with conflict transactions (such as a management buyout) or other major corporate events (such as shareholder litigation or a hostile takeover bid) or to address particular special investigations or projects. While the use of special committees is perfectly appropriate and useful in many circumstances, such committees are also often used in situations where it might be best to keep the matter in question before the full board (or before all of the outside members of the full board). Special committees can sometimes become divisive in sensitive situations and there is a risk that the special committee and its chosen outside advisors may take a matter in a direction that would be different than that desired by the full board. Especially in matters of great sensitivity it is often preferable for all directors (or at least all outside directors) to remain active in monitoring the direction of the matter.

The work of the board will be facilitated by establishing the appropriate relationship between the board as a whole and each of these committees, so that the work of the committees is neither duplicated nor ignored by the board. The significant actions of the

committees should be understood by the board as a whole and integrated into the overall work of the board. In order to enable both the board and its committees to deal with any special problems that may arise in the course of performing their duties, the board and its standing and special committees should be granted the authority to engage independent counsel where appropriate. That said, this authority should be used sparingly; as a general rule, a board or board committee should resort to it only when there is a real conflict or some other genuine need for independent or specialized advice. More often than not, a company's own general counsel or CFO can provide more pertinent advice and insight than that available from outside sources.

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.

Executive sessions. The NYSE requires the non-management directors to meet in regularly scheduled executive sessions of the board in which management is not present. Each board should determine the frequency and agenda for these meetings. These executive sessions should be viewed primarily as a safety valve to deal with problems and not a forum for revisiting matters already considered by the full board. The executive sessions should not usurp functions that are properly the province of the full board.

Board and committee agendas. The board and its committees should be proactive in working with senior management and the general counsel in setting their agendas for the year as well as for each board or committee meeting. While it is the management, not the board, that must set the strategic and business agenda for the company, including regulatory and compliance goals, directors should take a leadership role in defining the bounds of their oversight and responsibilities. The meeting and annual agendas should reflect an appropriate division of labor and should be distributed to the board or committee members in advance.

Separating roles of Chairman and CEO; lead director. Most American companies have traditionally had a single individual who carries the titles of both Chairman of the Board and CEO. While some shareholder activists have recently called for the separation of these roles, both ISS and TIAA-CREF leave this matter to the discretion of the board, provided that there is a lead director who presides over executive sessions of the board. While there is no formal requirement in the NYSE rules or in the Sarbanes-Oxley Act that a company have a lead director, the independent directors should have a leader who is not also the CEO. With such a leader, directors who have concerns about the company and its performance have a go-to person with whom they can discuss those concerns and have them relayed, where appropriate, to the full board. Whether he or she is called the lead director, the non-executive chair or the presiding director, this leader should have the following key roles: (1) be available to consult with the CEO about concerns of the board of directors; (2) be available to be consulted by any of the senior executives of the company as to any concerns the executive might have and (3) preside at

executive sessions of the board – without the CEO being present – prior to or following certain of the regular meetings of the board. In order to be effective, he or she should be a senior person who is highly respected and regarded by the CEO and the other directors. The lead director is not an officer and would not have any of the formal duties of a chairman of the board, but he or she is the director who would assume leadership of the board if a need to do so should arise. A company might either have a single individual designated as a lead director or have a presiding directorship through which the committee chairs rotate. If a lead director is designated, the NYSE requires his or her name to be disclosed in the annual proxy statement. Alternatively, a company may disclose the procedure by which a presiding director is selected for each executive session.

Whistleblowers. Boards, and in particular audit committees, are required to establish procedures to enable employees to confidentially and anonymously submit concerns they might have regarding the company's accounting, internal controls or auditing matters. In addition, companies are subject to potential civil, and in some cases criminal, liability if they can be shown to have taken retaliatory action against a whistleblower who is an employee. In responding to these new constraints, there can be a temptation to establish a special committee of independent directors to investigate every single whistleblower complaint. This temptation should be resisted in favor of a procedure that filters whistleblower complaints, as such investigations can be extremely disruptive. SEC Enforcement Director Stephen Cutler recently urged companies to appoint a permanent ombudsman or business practices officer to receive and investigate complaints. Boards should ensure the establishment of an anonymous whistleblower hotline and a well-documented policy for evaluating whistleblower complaints, but they should also be judicious in deciding which complaints truly warrant further action.

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.

As the Blue Ribbon Commission on Board Leadership of the National Association of Corporate Directors recently recommended, the first decision a board must make

during a crises is to decide whether the CEO should lead the corporation through the crises, noting that "if he or she is part of the problem or is otherwise compromised or conflicted, someone else — often one of the other directors — should take a leadership role." If the CEO is not compromised or conflicted, the CEO should lead the corporation's response to the crisis.

Each crisis is 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 environment, the corporation should give careful attention to 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 determining 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 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, 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 determine 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 avoid creating ambiguous records that may be used in litigation against the corporation and the board.

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.

Shareholder activism; proxy advisors. One of the most visible byproducts of the Enron-type scandals is the increase in shareholder-sponsored precatory proxy resolutions and the high level of shareholder support that they are able to command. For the first time in 2003 and 2004, over 1,000 shareholder proposals were submitted to corporations (with over 400 on corporate governance alone in 2004), with record numbers of those resolutions achieving majority support among shareholders. On some issues, mostly related to antitakeover defenses, shareholder proposals now routinely receive majority support. One of the explanations for such shareholder support is the demise of "case-by-case" voting by institutional shareholders. Today, institutional shareholders, who control over 60% of stock in American corporations, typically subscribe to the services of proxy voting advisors, such as ISS, to provide analysis or advice with respect to shareholder votes. These proxy voting advisors publish proxy voting guides setting forth blanket voting policies on a variety of common issues that are frequent subjects of shareholder proposals. Institutional shareholders typically do not review individual shareholder proposals on a company-by-company basis. Instead, they rely heavily on these proxy voting guidelines, regardless of an individual company's performance or governance fundamentals. As a result, many shareholder votes are foreordained by a voting policy that is applied to all companies without reference to the particulars of a given company's credentials. The emergence of new proxy advisory services, such as Proxy Governance Inc., that promise to review issues on an "issue-by-company" basis is a recent development that should be welcomed.

A recent trend that has added significant pressure to boards that are considering majority vote resolutions is the growth of "withhold-vote" campaigns, as well as just-vote-no campaigns against single issues such as equity compensation plans. In recent years, shareholder activists have been increasingly willing to sponsor or support withhold vote campaigns against directors for a variety of perceived infractions, including issues of independence and the unwillingness of a board to implement shareholder resolutions that receive majority shareholder support. This year, in an effort to further increase the pressure of withhold-vote campaigns, a group of labor unions have submitted precatory proxy resolutions to more than 75 corporations urging amendments to governance documents to require that directors be elected by a majority rather than a plurality of the votes cast. Another factor that magnifies the power of shareholder proposals as an activist tool is the effect of corporate governance metrics on the rating and general public evaluation of companies, as organizations like ISS include responsiveness to shareholder proposals among the factors they consider in determining a corporate governance score.

In dealing with shareholder proposals, 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 contact between shareholders and non-management directors 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. As companies spend more time and effort to consider shareholder proposals, and especially majority vote resolutions, it might make sense to formalize the process by which this is done. By paying serious attention to shareholder proposals, and by being proactive in shareholder communications and disclosure, boards are most likely to create the right environment for acting on shareholder resolutions even when the ultimate determination may be to reject them.

Shareholder access. In 2003, the SEC proposed a new proxy rule that would enable shareholders to directly nominate a director through the corporation's own proxy. This proposed rule promises to magnify the problems associated with the voting power of institutional shareholders, creating the risk of an influx of special interest directors selected, in effect, by parties that have no legal duties or obligations to the public company or its shareholders at large and no special expertise in the company's industry. It also threatens to create annual election contests, which will cause significant disruption to management's operation of the company's business, and is likely to compromise, if not destroy, the collegiality of the board, creating an unproductive working environment. At this time, it appears that the SEC proposal will not be adopted and that the SEC will not require corporations to include precatory resolutions in their proxy statements seeking amendments to governance documents that would provide the same shareholder access as the proposed SEC rule.

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.

Indemnification, D&O coverage. All directors should be fully indemnified by the company to the fullest extent permitted by law and the company should purchase a reasonable amount of D&O insurance to protect the directors against the risk of personal liability for their services to the company. Bylaws and indemnification agreements should be reviewed on a regular basis to ensure that they provide the fullest coverage permitted by law. Having in place governance procedures that are responsive to the recent legislative and regulatory initiatives and that reflect best practices, and having a robust record reflecting strong, good faith efforts to adhere to those procedures, will be helpful in assuring that a court respects the applicability of exculpatory charter provisions in any litigation that might arise.

D&O coverage provides a key protection to directors. While such coverage has become more expensive in recent years, it is still available in most instances and remains highly useful, despite some recent decisions construing the terms of D&O policies less favorably to the insured. In this regard, it is important to note that D&O policies are not strictly form documents and can be negotiated. Careful attention should be paid to retentions and exclusions, particularly

those that seek to limit coverage based upon a lack of adequate insurance for other business matters, or based on assertions that a company's financial statements were inaccurate when the policy was issued. Care should also be given to the potential impact of a bankruptcy of the company on the availability of insurance, particularly the question of how rights are allocated between the company and the directors and officers who may be claiming entitlement to the same aggregate dollars of coverage. To avoid any ambiguity that might exist as to directors' and officers' rights to coverage and reimbursement of expenses in the case of a bankruptcy, many companies are purchasing separate supplemental insurance policies covering only directors and officers and not the company (so-called "side-A" coverage) in addition to their normal policies which cover both the company and the directors and officers individually.

The Business Judgment Rule. 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 performance. 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. They should inquire with due care to make sure that the corporation is operating in compliance with applicable laws and regulations and, insist that management take the requisite responsibility for ensuring the accuracy and completeness of the corporation's financial statements and public disclosures.

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 and, more generally, management's obligation to take all necessary corrective actions when compliance failures or deficiencies are noted. That said, inroads on the Business Judgment Rule have doubtlessly been made – particularly in the change of control context and perhaps in connection with other high-profile issues such as executive compensation. Under today's dominant "monitoring" board concept greater engagement by directors is demanded. Yet while the change in social expectations from directors is quite real, ultimately the tool of director liability is too crude, too socially costly an implement to be deployed except very rarely, and the courts have to date exhibited a keen understanding of this fact. While it is true that courts and regulatory authorities have little tolerance today for directors who are simply sleeping at the wheel, it remains a verity of Delaware corporation law that the Delaware courts will not hold a director to be liable for a loss caused to the company if the court perceives that the director was actually trying to advance a legitimate corporate interest.

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 judgment prove flawed, the director will not be faulted.

In the words of Norman Veasey, former 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.