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# Some Thoughts for Boards of Directors in 2006

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In 2006 three topics will dominate boardroom discussion: (a) executive compensation, (b) majority voting for election of directors and (c) the relative merits of short-term stock performance and long-term company value in the context of greatly increased pressure from activist shareholders. As a result of Delaware's affirmation of the business judgment rule in the Disney case last August, there will be less concern regarding personal liability for directors.

Activist shareholders will use the issue of majority voting and the threat of withholding votes from members of the compensation committee to try to "control" executive compensation. Similarly, hedge funds and other activist shareholders will use withhold-vote campaigns, or proxy fights to elect a short slate or a full slate, to pressure boards to take actions designed to produce an immediate increase in the market price of a company's stock. The Time-Warner and McDonald's situations in 2005 are prominent examples of hedge fund activism to direct corporate strategy, and they demonstrate that even very large companies are not immune from this activity.

The Disney decision alleviated the concern that the post-Enron accounting and corporate governance reforms would diminish the business judgment rule and create new bases for director liability. However, boards should not lose sight of the fact that the post-Enron reforms have imposed new responsibilities on directors. Directors today must navigate a sea of legal and regulatory requirements, including federal securities laws, federal sentencing guidelines, stock exchange governance requirements and state laws. On top of all this, state attorneys general and shareholder activists are seeking to mandate or suggest new director responsibilities and changes in the role of the board.

In order to assist directors in discharging their duties, accounting, consulting and legal advisors have generated an almost endless parade of best practices, stylized agendas, checklists, director education programs and extra meetings. Some of these undoubtedly will contribute to improved compliance, 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.

In order to avoid an overemphasis on process and at the same time effectively discharge the board's 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 my 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.

***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 it is still generally acknowledged that a combination of the two is necessary, and that only a collegial board can function effectively over the long run. To be truly effective, each board must find the right balance between monitoring and advising as to strategy. Finding this balance is the critical starting point in any consideration of how to structure the membership and the operations of a board.

***Tone at the top***. One of the most important factors in ensuring that a board functions effectively and meets all of its responsibilities 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 for 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 other most important job of the board is selecting and evaluating the CEO and the senior executive leadership of the corporation and planning for their succession. 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 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 responsibilities. In large measure, the fate of each of the board and the CEO is in the hands of the other.

In choosing a CEO it is not necessary to conduct a search of outside candidates. A proven competent internal candidate, who knows the corporation's business and culture, is frequently the best choice.

***Effectiveness of the board***. It has been 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.

Retreats might be rotated among locations 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. 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, corporations should provide education programs for continuing directors, both to enhance their skills as directors as well as to help them stay abreast of regulatory and corporate governance developments.

***Separating roles of chairman and CEO; lead director.*** Most American companies have traditionally had a single individual who combines the roles of both chairman of the board and CEO. While some shareholder activists have called for the separation of these roles, most institutional shareholders and their advisors leave this matter to the discretion of the board, provided that there is an independent 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. 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 discuss with the other directors any concerns they may have about the company and its performance and relay these concerns, where appropriate, to the full board; (2) be available to consult with the CEO regarding the concerns of the directors; (3) be available to be consulted by any of the senior executives of the company as to any concerns the executive might have and (4) preside at executive sessions 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.

***Independence.*** Today, 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. Although the NYSE requires only that a majority of the board be independent, today most boards have only one or two directors who 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 directors as remote strangers and the board as the agency for the discipline of management, rather than as advisor to 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.

That said, as a general rule, a director must be careful in the current environment to make full and complete disclosure of any relationships or transactions that could be deemed to affect independence. Many relationships that may have been considered commonplace in the past (such as a director's involvement with a nonprofit organization that is 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. A practical way to deal with those situations is that where such relationships might raise an issue as to the independence of the directors acting on a *particular* matter, consideration should be given to delegating that matter to a committee of directors each of whom is free of such relationships.

***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 fully in an interactive dialogue with the board. Many companies find it productive to include an annual strategy review in a board retreat as described above.

***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. The nominating committee should have the flexibility to determine the mix of qualifications and attributes that is best suited to the specific needs of the corporation.

***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 also should 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.

***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 committees 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. While the final determination is that of the committee, there is no restriction on full discussion with the CEO. The committees have the authority to retain consultants, but 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 such assistance.

All companies, as part of their broader governance reviews, should carefully consider which directors satisfy the requirements for service on committees. Questionnaires may be used to determine and document both independence and qualification for committee assignments. In addition to these core committees, boards may wish to establish 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 may 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 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 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 dealing with the matter.

The work of the board will be facilitated by establishing the appropriate relationship between the board as a whole and each of its 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 have the authority to engage independent advisors 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 corporation's own general counsel or CFO can provide more pertinent advice and insight than that available from outside sources; so too can outside counsel that has a substantial continuing relationship with the corporation, rather than "independent" counsel that has had no relationship with the corporation.

***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 monitors 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.

***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 management, not the board, that must initiate 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 agendas and the overall annual agenda should reflect an appropriate division of labor and should be distributed to the board or committee members in advance.

***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. They provide the opportunity for meaningful review of management performance and succession planning. In addition, they are a safety valve to deal with problems. They should not be used as 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.

***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 may 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.

***Minutes.*** Careful and complete minutes should be kept of all board and committee meetings. The minutes should reflect the discussions and the time that was spent on significant issues, both in the meeting and prior to the meeting. The minutes should also reflect all those who were present at the meeting and the matters for which they were present or recused. Increasingly, courts and regulators have raised questions about the amount and scope of attention that was spent on a matter when the minutes did not contain an adequate description. Depending on the matters considered at executive sessions, it may be appropriate to have summary minutes or in some cases very extensive or even verbatim minutes of such sessions.

***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 corporate performance 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. 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 media and gadfly attention 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 emphasize the importance of transparency and full disclosure of compensation packages. The minutes of the compensation committee should reflect discussion and full understanding of every element of the compensation approved.

The SEC has stated that it intends to promulgate new rules in 2006 that will require increased disclosure of executive compensation. In addition, a bill has been introduced

in the House of Representatives to require not only increased disclosure, but also shareholder approval of additional pay for top executives when a company is being sold.

ISS has adopted a formal policy for 2006 to recommend withholding votes from compensation committee members if the company has poor compensation practices, which ISS considers to include, but not be limited to, the following:

- Egregious employment contracts including excessive severance provisions;
- Excessive perks that dominate compensation;
- Huge bonus payouts without justifiable performance linkage;
- Performance metrics that are changed during the performance period;
- Egregious SERP (Supplemental Executive Retirement Plans) payouts;
- New CEO with overly generous new hire package;
- Internal pay disparity; and
- Other excessive compensation payouts or poor pay practices at the company.

In addition, ISS has developed a table that sets forth its view of the minimum disclosure for CEO pay.

***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.

***Shareholder activism; proxy advisors; majority voting in director elections.*** 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. On some issues, mostly related to anti-takeover 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 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 situation.

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, 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.

Currently the effort by activist shareholders to persuade corporations to adopt majority voting for election of directors has developed significant shareholder support. The Council of Institutional Investors has written to 1,500 corporations requesting that they adopt majority voting, the Committee on Corporate Laws of the American Bar Association has released a discussion paper highlighting the issues involved in switching to majority voting and a committee in Delaware is considering whether its corporation law should be amended. General Electric, Pfizer, Office Depot and Disney, among others, have amended their corporate governance guidelines to require that any director who receives a majority of withheld votes submit his or her resignation to the board, leaving the outcome in the hands of the board.

In November 2005, ISS announced a majority voting policy providing that ISS will consider not recommending a vote for a precatory or binding shareholder proposal requiring that directors be elected by an affirmative majority of votes cast if the company has adopted a formal majority-vote-corporate-governance principle that presents a "meaningful alternative." The governance principle must incorporate the following elements to adequately address each new and incumbent director nominee who fails to receive an affirmative majority of votes cast in an election:

- Annual proxy statement disclosure of the established guidelines for the process to be followed regarding the nominee;

- A clear and reasonable timetable for all decision-making regarding the nominee;

- Management of the process by independent directors, and exclusion from the process of the nominee at issue;

- An outline of a range of remedies that can be considered regarding the nominee; and

- Prompt disclosure of the final decision in an SEC filing, including a full explanation of how the decision was reached.

A company adopting such a governance principle should also explain why the principle is the "best structure" at such time in terms of accountability to shareholders. ISS, in reaching its recommendation on a majority vote proposal, will review a company's history of accountability to shareholders, including taking into account a classified board structure and a history of ignoring majority approved shareholder proposals.

It is clear today that majority voting will become universal. In light of ISS' position and in an effort to avoid shareholder proposals for proxy inclusion and subsequent requests for no-action relief from the SEC, it is advisable for companies to adopt proactively a corporate governance principle that satisfies the ISS guidelines. Some majority voting proponents are insisting on a true majority vote requirement, rejecting the corporate governance principle approach of a tendered resignation and calling for the majority vote requirement to be included in a company's charter or bylaws and not the corporate governance guidelines. It remains to be seen whether the SEC will permit a company to omit from its proxy statement a precatory or binding shareholder proposal submitted under Rule 14a-8 if the company has addressed the issue in its corporate governance guidelines using a governance principle meeting ISS standards. It also remains to be seen whether a majority voting shareholder proposal which ISS does not recommend favorably (and which the SEC does not permit to be omitted from the proxy statement) will nonetheless garner support of institutional investors and be adopted by shareholders.

It is important to note that the ISS guidelines require that the corporate governance principle address the situation where the director nominee receives "withhold" votes from the ***majority of votes cast***, as opposed to a ***majority of the shares outstanding***, notwithstanding my best efforts to convince ISS to adopt the majority of the shares outstanding standard. While I continue to believe that that the majority of the outstanding shares standard is the better approach, I recognize that the position is not shared by ISS and some institutional shareholders and, because of the importance of discouraging an adversarial proxy proposal process, I recommend the adoption of a governance principle which satisfies ISS guidelines.

Given the "majority of the shares outstanding" approach one can expect some in the institutional investor community to continue to pressure the NYSE to alter its rules on broker voting for their customers who fail to do so. Wall street firms have traditionally used their discretionary voting power under NYSE rules to vote in favor of management those shares held in street name for which they have not received voting instructions from their clients. While the NYSE rules do not allow discretionary broker voting in contested situations, the NYSE has taken the position that withhold the vote campaigns are not considered contested situations. It is more important than ever that the NYSE not back away from this position, as doing so would in effect cause the passivity of a satisfied retail shareholder base to shrink the quorum, thereby overemphasizing the withhold vote count.

Shareholder activism would be further aided by a proposed SEC rule to permit Internet distribution of proxy statements. The proposal would make it less expensive for activist shareholders who are dissatisfied with incumbent directors to wage withhold-the-vote campaigns, or full proxy contests for board representation.

***Balancing short-term performance and long-term success.*** Activist shareholders, led by hedge funds which today have aggregate assets of more than one trillion dollars and armed with the threat of withhold-the-vote campaigns against directors, will exacerbate the tension between short-term performance and long-term success of the corporation. This is currently being manifested in the expanding demands by hedge funds to do a massive stock buyback funded by a sale of assets or to sell the entire company. While different in form, this hedge fund pressure raises management and board issues similar to those created by the pressure to give quarterly earnings guidance and then meet the targets. One of the best descriptions of this dilemma is set forth in an interview with Dr. Daniel Vasella, the CEO of Novartis, in the November 2002 issue of Fortune. The following is an excerpt from that interview:

> The practice by which CEO's offer guidance about their expected quarterly earnings performance, analysts set "targets" based on that guidance, and then companies try to meet those targets within the penny is an old one. But in recent years the practice has become so enshrined in the culture of Wall Street that the men and women running public companies often think of little else. They become preoccupied with short-term "success," a mindset that can hamper or even destroy long-term performance for shareholders. I call this the tyranny of quarterly earnings.
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> Let me say straight off, there is nothing inherently wrong with delivering consistent results, quarter after quarter—that is the mark of a great company, after all, when it is done over time. (And to be sure, one cannot achieve substantial long-term rewards for shareholders without delivering many, many short-term periods of outperformance along the way.) But tyranny is a slippery thing. Rarely does it make itself known for what it is right from the start. Once you get under the domination of making the quarter—even unwittingly—you start to compromise in the gray areas of your business, that wide swath of terrain between the top and bottom lines. Perhaps you'll begin to sacrifice things (such as funding a promising research-and-development project, incremental improvements to your products, customer service, employee training, expansion into new markets, and yes, community outreach) that are important and that may be vital for your company over the long term.
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> For me, for example, the challenge might be whether or not to strike a deal with a biotech company that is currently running a trail of red ink. Should I decide not to make the deal because I'd then have to consolidate the losses for three years, even though the value of the investment would in all likelihood be positive for the company over time? Do I personally have the strength of my convictions to face the impact of short-term negative results—to say to shareholders, "We invested in this company, and our earnings will grow 3 cents less than expected"? Trust me, it is often a difficult question to answer. And then there is the opposite

> scenario. Should Novartis leverage its balance sheet to do risky acquisitions or ones that may simply be a poor fit for the company instead of investing in organic growth? True, our earnings and revenue streams may improve in the short term, but at what cost? Or—and we have seen this too many times in recent months—you start to play games with the numbers, digging a hole that over time becomes deeper and deeper, always hoping that you can fill it back up later. In reality, though, you can't cover up that hole forever.

As so cogently described by Dr. Vasella, the short-term, long-term debate will be a major focus in boardrooms of companies confronted by demands for stock buybacks or sale of the company and the threat of a withhold-the-vote campaign or a proxy fight. The critical factor in these confrontations will be whether the major institutional investors will support companies that have reasonable plans and prospects for long-term success and growth or whether they will insist that those plans be truncated for a quick increase in the price of the stock.

In 2006 boards will be confronted with two other short-term versus long-term issues: (a) pension plan funding and accounting (now the subject of pending federal legislation) and (b) leveraged buyout proposals from the increasingly aggressive private equity funds (which individually are capable of deals in the $5 billion range and by forming "clubs" are capable of deals in the $25 billion range).

***The Disney case.*** The decision of the Delaware Chancery Court in the Disney case reaffirmed that the business judgment rule is alive and well. The Disney decision also delineated the scope of protection of directors against personal liability for claimed breach of fiduciary duty. Negligence — that is, a failure to use due care — will not result in personal liability unless the director failed to act in "good faith." The court ruled that "intentional dereliction of duty, a conscious disregard for one's responsibilities" is an appropriate test for determining whether a director has acted in good faith. The court ruled that a director fails to act in good faith when the director (1) "intentionally acts with a purpose other than that of advancing the best interests of the corporation," (2) "acts with intent to violate applicable positive law," or (3) "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." The court also said that although it strongly encourages directors to employ best practices of corporate governance, as those practices are understood at the time a board acts, directors will not be held liable for failure to comply with "the aspirational ideal of best practices." In other words, directors will have the benefit of the business judgment rule if they act on an informed basis, in good faith and not in their personal self interest, and in so doing they will be free from "*post hoc* penalties from a reviewing court using perfect hindsight."

There are two principal sources of potential personal liability for directors: state law fiduciary duties and federal securities laws. As affirmed in the Disney case, the business judgment rule protects directors from state law liabilities. If a director acts with due care, does not have a conflict of interest and believes that he or she is acting in the best interests of the corporation, the director will be protected by the business judgment rule. The guidelines in this memorandum provide directors with a roadmap for staying well within the protection of the business judgment rule.

The federal securities laws pose a greater threat of personal liability than state law fiduciary duties. Last year's WorldCom and Enron settlements, in which the directors

agreed to personal payments, were federal securities law cases. Directors are liable for material misstatements or omissions from registration statements the company has used to sell securities unless the directors prove that they exercised due diligence. To meet their due diligence requirements, directors must carefully review and understand the registration statements and other disclosure documents that the corporation files with the SEC. In doing so the directors can rely on the accountants with respect to the audited financial statements and on other experts, provided that the directors have no reason to believe that the expert is not qualified or is conflicted or that the disclosure is actually false or misleading. Directors should not merely accept management's representations that a registration statement is accurate, and are well advised to have their corporation's legal counsel present for the directors' review of all SEC disclosure documents and receive the advice of counsel that the process they have followed fulfills their due diligence.

***Reliance on advisors.*** 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, have direct access to the board, if ever needed.

***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. The Council of Institutional Investors and other shareholder advisory organizations have recognized the need for adequate director compensation and have published guidelines.

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.

***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 oversee the management of the corporation by monitoring the performance of the CEO and senior officers. For the board to monitor performance, the board and management together need to determine the information the board should receive. Here, "less can be more." 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 the information that it determines to be useful to it. The board should consider annually whether it is receiving the appropriate information and make adjustments as necessary. Basically, the board should receive financial information that enables it to readily understand results of operations, variations from budget and trends in the business and the corporation's performance relative to peers. In addition, 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 request 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 should 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 that 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 or another committee. However it is done, it is a desirable practice for the board or the committee to meet regularly in executive session with the general counsel of the corporation. Where there is a serious investigation or litigation that is being handled by outside counsel, such counsel should report directly to the board or the committee. In addition, the board should oversee an annual review of the corporation's compliance and governance programs and its information and reporting systems and receive the 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 decision-making, even when the outcome is to take no action.

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 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.

***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. Boards have responded to recent crises with varying degrees of success. 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.

The first decision a board must make during a crisis is to decide whether the CEO should lead the corporation through the crisis. If the CEO 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 general 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.

***Whistle-blowers.*** 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 whistle-blower 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 whistle-blower complaint. This temptation should be resisted in favor of a procedure that filters whistle-blower complaints, as such investigations can be extremely disruptive. The SEC has urged companies to appoint a permanent ombudsman or business practices officer to receive and investigate complaints. Boards should ensure the establishment of an anonymous whistle-blower hotline and a well-documented policy for evaluating whistle-blower complaints, but they should also be judicious in deciding which complaints truly warrant further action.

***Review of controls and risk management.*** The board should also — whether directly or through the audit committee – review whether management has adopted and implemented proper risk assessment and risk 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 review whether 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. The rules also call for a quarterly evaluation and certification by management of a company's internal controls and procedures for financial reporting. 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 (through the audit committee) 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, while "reasonable assurance" is a high standard, it is not an absolute, and boards should avoid overreaction to the discovery of deficiencies.

***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.*** Generally boards are not comfortable with related party transactions and today most companies avoid them. However, there is nothing inherently improper about transactions between a corporation and its major shareholders, 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.

***Indemnification, exculpation and D&O coverage.*** The Disney decision notwithstanding, shareholder litigation against directors continues. All directors should be 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 available. 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.

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. Directors should also consider 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.