Some Thoughts for Boards of Directors in 2009

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I. INTRODUCTION

Over the past year and a half, a perfect storm of economic conditions has triggered an extraordinary downward spiral: the subprime meltdown, liquidity crises, extreme market volatility, controversial government bailouts, consolidations of major banking institutions and widespread economic turmoil both domestically and abroad. Many corporations now find themselves in uncharted territory, with a new paradigm of unpredictability trumping formerly reasonable expectations. In the coming year, boards of directors will need to respond to the challenges and pressures of this new environment. This may include reassessing their agendas, committee structures, time commitments and director recruiting, as well as their role in monitoring performance, compliance and risk management. At the same time, boards need to maintain the collegiality and culture of a common enterprise with the CEO and senior management. In short, the task for boards is not simply to go into crisis mode in order to deal with current issues, but rather to take a more holistic, long-term approach to reassessing their proper role and functioning.

In reviewing their monitoring and oversight roles, boards should be mindful of the shifting legal and regulatory landscape. Although the standard for director liability established in Delaware by the Caremark case accords directors considerable deference in fulfilling their oversight duties, there is a distinct possibility that this level of deference could end up being modified in light of the current economic crisis. The spate of litigation generated by the market turmoil will intensify the scrutiny of some boards and will provide courts with repeated occasions to consider second-guessing board decisions. Various regulators have been focused on risk management policies, some of which have found their way into new federal legislation, and numerous new guidelines and "best practices" purport to raise the bar. As financial losses accumulate, shareholders and the public at large will seek to hold boards and management accountable, and there will be tremendous pressure on corporations to demonstrate that they are responding to the current challenges.

The economic crisis is also propelling a more general critique of board performance and corporate governance. To be sure, the 2008 proxy season was relatively muted, as shareholders were focused on corporate stability and activist concerns were eclipsed by more fundamental economic upheavals. However, steep financial losses will make corporations vulnerable to renewed attacks by activists and potential acquirors, in addition to pressures from regulators and the political sphere. Recently, there have been strident editorials demanding the resignation of directors of companies that have performed poorly and are seeking government financing. In responding to the financial crisis, the government has become more actively involved in corporate governance matters, both in its capacity as a regulator as well as in its new role as a shareholder of many corporations. There is considerable public anger and momentum for reforms, particularly with respect to executive compensation issues.

While it is clear that there will be a regulatory response to the economic crisis, the contours and extent of the reforms are still evolving. To the extent that boards can be proactive in addressing new challenges and mitigating risks, there may be some window of opportunity for them to help shape the regulatory response, and steer it toward pragmatic measures that will promote rather than impede the creation of long-term shareholder value.

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This memorandum sets forth some of the significant issues that boards of directors face in the coming year, as well as some practical considerations to bear in mind. 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 meriting the board's focus and create a reasonable program to deal with them. Some are perennial themes that remain relevant and deserve to be reemphasized from year to year, whereas others have come into particular focus in recent years. It is important to note, however, that "one size does not fit all." The board of each corporation can and should focus on its own particular issues and tailor procedures to its own circumstances.

II. SOME KEY ISSUES FACING BOARDS IN 2009

1. <u>Risk management</u>

Companies today must manage a remarkably complex, interconnected and rapidly evolving set of risks, and the ability of boards of directors to effectively oversee the risk management function is critical to the success of the enterprise. Although the financial crisis initially precipitated a focus on risks relating to subprime and financial instruments, it is clear that boards need to take a comprehensive view of their companies' risk profiles and appreciate risk in all its dimensions — including business, operational, financial, liquidity, legal, compliance and reputational risks, among others. Boards should assess potential vulnerabilities based on a range of market scenarios and determine an appropriate appetite for risk. Companies need to incur risk in order to run their businesses, and there can be danger in excessive risk aversion, just as there is danger in excessive risk-taking.

The board's role is one of informed oversight rather than direct management of risk. The board cannot and should not be involved in the day-to-day risk management activities. Directors should instead satisfy themselves that the risk management processes designed and implemented by executives and risk managers are adapted to the board's corporate strategy and are functioning as directed, and that necessary steps are taken to foster a culture of risk-adjusted decision-making throughout the organization.

Risk management should be tailored to the specific company, but in general an effective risk management system will: (1) adequately identify the material risks that the company faces in a timely manner, (2) implement appropriate risk management strategies that are responsive to the company's risk profile and specific material risk exposures, (3) integrate consideration of risk and risk management into business decision-making throughout the company, and (4) include policies and procedures that adequately transmit necessary information with respect to material risks to senior executives and, as appropriate, to the board or relevant board committee. In addition to addressing known risks and vulnerabilities, the system should entail an ongoing effort to assess and analyze the most likely areas of future risk for the company. The board should periodically review the company's risk management and monitoring systems and ask management and/or outside consultants for an assessment of the systems' adequacy. It must be sensitive to "red flags" and "yellow flags" and should investigate them as appropriate.

Last month we issued a special memorandum that contains a more detailed discussion of risk management issues facing companies and their boards today. A copy of that memorandum may be accessed at this link: Risk Management and the Board of Directors.

2. Executive compensation

In the current economic environment, executive compensation practices are subject to significant political and public scrutiny. Although this has been a hot button issue in recent years, the attention it is receiving from activists, regulators and the general public has reached new heights. The publicity surrounding top executives who have received sizable severance, bonus and other payments from companies struggling with the economic crisis, especially companies that are recipients of federal bailout funds, has prompted numerous calls for investigation and reform. Executive compensation policies have been criticized not only for payments that are deemed excessive, but also for encouraging excessive risk-taking and contributing to financial instability at both institutional and systemic levels.

The 2008 financial bailout legislation requires companies participating in the bailout program to adhere to certain restrictions on executive compensation policies, including standards to ensure that incentive compensation for senior executives does not encourage unnecessary and excessive risks, clawback requirements for compensation paid on the basis of earnings, gains or other criteria that are later found to be materially inaccurate and a prohibition on golden parachute payments. Two activist labor funds have stated, however, that these compensation restrictions "fail to adequately address the serious shortcomings of many executive compensation plans," and they have filed or plan to file a shareholder proposal at approximately 50 companies that calls for further limitations. In addition, RiskMetrics has expanded its list of "poor pay practices" for 2009 to include the adoption of new change-in-control agreements that include "golden parachute" excise tax gross-ups, tax gross-ups on executive perks and other compensation measures.

"Say-on-pay" policies that would give shareholders a non-binding advisory vote on executive compensation have also been gaining traction. In April of 2007, the U.S. House of Representatives approved say-on-pay legislation, and then-Senator Barack Obama sponsored a companion bill in the Senate. Several U.S. companies have put annual pay-ratification votes on their ballots or have committed to doing so, and RiskMetrics has reported that say-on-pay proposals in 2008 received an average level of shareholder support of 42 percent at 69 meetings.

In this environment, boards and compensation committees should review compensation policies with great care, being mindful of pay-for-performance principles while also seeking to avoid policies that will encourage excessive risk-taking. Boards should utilize the CD&A in their companies' proxy statements and related executive compensation disclosures to explain and emphasize the ways in which they have employed pay-for-performance principles. In addition, as suggested recently by the Director of the SEC's Division of Corporation Finance, they should use the CD&A to describe the impact of incentive structures on risk management. At the same time, the board and compensation committee should not lose sight of the underlying goal of executive compensation, namely to attract and retain qualified individuals. Structuring compensation arrangements that meet all these objectives is increasingly complicated in an environment that features lower equity values and challenging, volatile macroeconomic forces. However, in the final analysis, the ability to recruit and retain world-class executives is essential to the long-term success of the corporation.

3. CEO succession planning

In the current environment, CEOs and senior management have been under tremendous pressure from shareholders, employees, customers and other constituencies to manage difficult market conditions, and not surprisingly, several surveys have reported a recent upward spike in the CEO turnover rate. As a result, the board's role in selecting and evaluating the CEO and the senior executive leadership, and planning for their succession, has never been more important. A protracted delay in finding a suitable replacement can detract significantly from the stability of a company and its ability to react quickly and decisively to rapidly evolving challenges.

In fulfilling its evaluation and succession planning functions, 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, and the expertise and qualifications of the CEO are decisive factors in the success of a corporation. In large measure, the fate of each of the board and the CEO is in the hands of the other. There are no prescribed procedures for succession planning and selecting the CEO, and the board should fashion the principles and procedures it deems appropriate. For example, in choosing a CEO, the board should not feel required to conduct a search for outside candidates. A proven, qualified internal candidate, who is intimately familiar with the corporation's business and culture, is frequently the best choice.

4. Takeover defense

The current significant stock price declines and depressed valuations of many public companies may invite bargain hunting by potential acquirors who are able to obtain financing or use their shares for acquisitions. When the economy begins its slow path to recovery and market conditions stabilize, some companies will find they have recovered enough to pursue acquisition targets, while those that lag behind may be targeted by the acquirors. Many companies may find they are more vulnerable than ever as a result of the sustained attack by shareholder activists on takeover protections in recent years. By way of example, Anheuser-Busch succumbed to a hostile takeover this year after repealing its classified board in the name of adherence to "best practices in corporate governance."

Boards should review their takeover defenses and areas of potential exposure to pressure tactics, taking into account changes in the legal, regulatory and financial environments. Companies should monitor their shareholder base and maintain updated lists of key contacts. In addition, the board should regularly assess the company's strategic plan, maintain a unified board consensus on key strategic issues and oversee the development of business, financial and legal strategies to avoid or counter attacks. It is essential to be able to mount a defense quickly and to have flexibility in responding to changing takeover tactics. In this regard, preparedness can be a determinative factor. Boards may also wish to update advance notice bylaws and shareholder rights plans to address the synthetic and temporary stock ownership techniques that have been used by activists to avoid disclosure requirements or to acquire voting power that does not necessarily correspond with their economic stake.

5. Short-termism and special interest groups

It is particularly important for boards to take a long-term perspective when setting the strategic direction and goals of their companies. The recent market volatility and economic

uncertainty have created pressing challenges that need to be navigated in the near future. However, an unduly narrow focus on short-term issues risks repeating some of the very mistakes that contributed to the current market turmoil: excessive risk-taking to generate positive short-term results, or conversely, reluctance to make investments that require a long-term horizon. Boards should also consider all the constituencies of the corporation, which include shareholders, employees, creditors, customers and local communities, in determining how best to position their companies for long-term growth and value. This is the key advantage of the director-centric model of corporate governance: a strong, impartial board is best situated to resist pressures for short-term gains and balance competing interests to promote long-term value.

Despite the benefits of the director-centric governance model, it is clear that activist investors, including hedge funds and other special interest groups, will continue their multi-pronged campaigns to shift decision-making power away from boards, and thereby exacerbate pressures to enhance short-term performance. The most obvious examples are demands by hedge funds for corporate actions that will directly result in short-term gains, including large or special dividends, diversion of capital expenditure to fund equity buy-backs, transactions that would reduce high-rated corporate debt to junk status, divestitures of businesses, facility closures and employee headcount reductions. 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, or whether a quick increase in stock price will be their priority.

The board's traditional function as a bulwark of long-term value is also being whittled down by activists in more pervasive ways. This is evidenced by the dilution of takeover defenses, the adoption of majority voting standards, proposals to enhance shareholder access to company proxy statements and reduce the costs of waging a proxy contest, withhold-the-vote campaigns, micromanagement by means of "best practices" and other reforms designed to supplant directorial judgment with shareholder prerogatives. Directors must be vigilant and proactive in seeking to balance short-term pressures against long-term goals, navigating procedural and compliance requirements and critically evaluating reformist agendas to determine for themselves what will further the best interests of the company and its constituents.

6. Director elections

Directors will continue to face opposition in the form of proxy contests and withhold-the-vote campaigns waged by shareholder activists, as well as campaigns by hedge funds seeking to influence short-term values. Directors may be particularly vulnerable to such opposition due to current market conditions; as companies continue to suffer financial losses and stock prices decline, directors are vulnerable to being blamed even where losses were precipitated by the convergence of broad economic trends over which they had no control.

The number of proxy fights increased sharply this past year, with RiskMetrics reporting that as of the end of August, there were 36 instances where a dissident filed a definitive proxy statement and 82 settlements of proxy fights, compared to 23 proxy fights and 52 settlements during the same period in 2007. In addition to director nominations, activists conducted several withhold-the-vote and vote-no campaigns, particularly with respect to directors who were criticized for risk management and compensation decisions.

The issue of shareholder access to company proxy statements for director nominations also remains on the horizon, both at the SEC and with potential legislative efforts. Proxy access is a serious mistake with far-reaching consequences — it would increase the frequency of contested director elections and deter qualified people from serving on public company boards, divert management time and attention, further encourage short-term thinking and lead to a rise in director candidates representing special interests. As an alternative to proxy access, directors may in some circumstances wish to seek more input from the company's major shareholders and solicit their views on potential director nominations. For example, after a review of stock option practices led to financial restatements at UnitedHealth Group, the company formed a nominating advisory committee composed primarily of representatives from shareholders to provide input into the company's search for new directors.

7. <u>Direct lines of communication with shareholders</u>

Companies have been increasingly willing to open direct lines of communication between directors and shareholders to discuss shareholders' views on performance, governance, social issues and political matters. Earlier this year, all of the six major banks that received requests from CtW Investment Group agreed to meet with CtW to discuss its concerns. Pfizer has held a full-day meeting with its largest shareholders to discuss executive compensation and other corporate governance issues, Home Depot directors have held a town hall meeting with shareholder activists, and some companies have begun to arrange corporate governance roadshows. Such meetings and communication forums may have benefits and may even be necessary in some situations to forestall a proxy initiative by shareholders, especially where a corporation has had significant compliance or performance issues.

However, boards should bear in mind both the advantages and disadvantages of these measures, and evaluate them on a case-by-case basis. Activists are not just seeking "listen only" sessions at which they make known their views and directors agree to give due consideration to their concerns. Instead, activists are incentivized to use the leverage of a potential proxy contest, negative publicity, shareholder resolutions and other pressure tactics to promote the ongoing, routinized brokering of private deals with companies on governance and other matters. Communication sessions with directors may increasingly be viewed as an entitlement of activists. In addition, this process can require considerable time and effort on the part of directors, distract attention away from critical operational and other matters, and undermine the CEO's role as primary spokesperson for the company.

In order to craft an appropriate response to requests for meetings, the board should take into account these competing concerns as well as the company's shareholder relations programs, and consider whether it is appropriate for the board or the lead director to have greater interaction with shareholders. To the extent that the board agrees to such meetings, it should take care to coordinate with management and all of the directors to avoid confusion or contradiction in the company's public posture, and adhere to the requirements of Regulation FD.

8. <u>Shareholder proposals</u>

In recent years, the prevalence and forcefulness of shareholder proposals have been escalating, and at the outset of the financial crisis last year, this trend was projected to continue its upward trajectory. As the subprime losses deepened and the crisis spread beyond the financial sector, attention appeared to shift from governance proposals and proxy contests to the

more pressing exigencies of corporate operating performance. Although some financial institutions did face significant activist efforts, RiskMetrics has reported an overall drop in the number of traditional governance proposals that were put to a shareholder vote in the first half of 2008.

It seems likely that this respite is temporary and, if history is any guide, the economic crisis may ultimately fuel another frenzy of activism. Directors should pragmatically evaluate whether shareholder proposals will in fact promote long-term value creation. Notably, a study issued earlier this year concluded that shareholder proposals do not measurably improve stock market or operating performance of target companies. Another fiction of the activist movement that has recently been undercut is the utility of corporate governance ratings, which are generally based on one-size-fits-all metrics and used by many companies to keep track of the latest governance dogma. Two recent studies by respected academics have concluded that governance ratings are not good predictors of corporate performance and caution companies against making governance changes solely to boost their ratings.

As part of a pragmatic approach, directors should consider whether shareholder proposals could be accommodated without significant difficulty or harm to the company. The responses of companies to shareholder proposals that receive majority support are carefully monitored by activists, and RiskMetrics, as a matter of policy, recommends a withhold vote when a board fails to be sufficiently responsive to a majority-supported proposal. By paying serious attention to shareholder proposals, and by being proactive in shareholder communications and disclosure, boards are more likely to create the right environment for acting on shareholder resolutions even when the ultimate determination may be to reject them.

In addition to activism targeted at shareholder meetings, directors should take note of developments in the regulatory and legislative arenas. For example, Carl Icahn announced this past October that he is launching a lobbying group to push legislators to pass more "pro-shareholder" laws, including legislation that sets limits on executive compensation and prohibits poison pills and classified boards. In addition, the corporate social responsibility framework outlined in a recently issued report of the Special Representative to the Secretary-General of the United Nations proposes yet another layer of expansive procedural and monitoring requirements for boards.

9. Separation of the chairman and CEO positions

One governance issue that gained traction this year is the separation of the positions of CEO and chairman of the board. RiskMetrics has reported that average shareholder support for these proposals increased this year by five percent to nearly 30 percent of votes cast. The issue attracted considerable publicity when family members of John D. Rockefeller joined a coalition of activist and pension fund investors and advocated a proposal to split the CEO and chairman positions at Exxon Mobil. Although the proposal ultimately received the support of only 39.5 percent of votes cast, the measure fared better at Washington Mutual, where it received 51.5 percent support of votes cast. Similar proposals at Time Warner, Pfizer and Weyerhaeuser received more than 40 percent shareholder support this year.

This issue will be back in 2009 and will likely continue to be promoted by governance activists. Companies that do not have an independent chair should have a lead director or a presiding director. In establishing the lead director position, the board should

consider which of the following duties the lead director should have: (1) presiding at board meetings at which the chairman is not present, including executive sessions of independent directors, (2) serving as a liaison between the chairman and the independent directors, (3) approving information sent to the board, (4) approving meeting agendas and meeting schedules of the board to assure there is sufficient time for discussion of all agenda items, (5) having the ability to call meetings of the independent directors and (6) if requested by major shareholders, being available for consultation and direct communication with major shareholders.

10. <u>Considerations in the "zone of insolvency"</u>

As the current economic crisis continues, boards may find themselves navigating the dangerous shoals of the "zone of insolvency" — the ill-defined gray area where a company is on the brink of becoming insolvent. Companies in the "zone of insolvency" face heightened risks of litigation, as board decisions are scrutinized by both shareholders and creditors. Some of the uncertainty in this area stems from state court cases that have suggested that directors owe fiduciary duties to creditors when a company is in the "zone." In 2007, a Delaware decision helped to clarify that, at least under Delaware law, creditors may not bring fiduciary duty claims against directors if the corporation was in the vicinity of insolvency, but was not actually insolvent, at the time of the alleged breach. However, once a company is actually insolvent, creditors are the residual beneficiaries of any increase in value of the company, and are also the principal constituency injured by fiduciary duty breaches that diminish this value. As a result, Delaware courts have established that creditors of an insolvent corporation have standing to bring derivative claims for fiduciary duty breaches.

Unfortunately, the line between solvency and insolvency can be murky, and the solvency of a corporation can rapidly deteriorate. Both shareholders and creditors may have different views as to whether and when the solvency line has been crossed, and both may seek to litigate these views and challenge board decisions with the benefit of hindsight. Accordingly, when a company is reaching the point of insolvency, directors must be mindful of the interests of creditors in addition to the interests of the company and shareholders. In such situations there is a significant risk of potential conflicts of interest among these constituencies.

In addition to fiduciary duty claims, state and federal statutes may impose liability for actions taken while a corporation was in the "zone of insolvency," such as dividends that render the company insolvent and transfers that may be deemed "fraudulent conveyances." In short, directors of financially distressed companies face some unique risks and complicated decisions, and such companies should seek the advice of outside financial and legal advisors with respect to, among other things, determinations of solvency, fiduciary obligations, and the legal and financial implications of turnaround strategies and capital-raising transactions.

III. THE ROLE AND DUTIES OF THE BOARD

While the board has always had a dual role as a resource for and advisor of management, on the one hand, and as an agent of shareholders on the other, regulators and activist shareholders have been tipping this balance in favor of the board's role in monitoring compliance with legal and accounting rules. The monitoring function has also gained increasing prominence as a result of the economic crisis, which has highlighted in particular the need for effective risk and compliance oversight. A combination of the two roles, however, is necessary for a board to be truly effective, and each board must find the right balance between monitoring

compliance and advising as to strategy. Finding this balance is the critical starting point in any consideration of how to structure the membership and operations of a board.

1. **Tone at the top**

One of the most important factors in ensuring that a board functions effectively and is able to meet all of its responsibilities is having the right "tone at the top" of the corporation. The tone at the top shapes corporate culture and permeates the corporation's relationships with investors, employees, customers, suppliers, regulators, local communities and other constituents. If the directors, CEO and senior management are not personally committed to high ethical standards, principles of fair dealing, professionalism, integrity, risk management, 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 fully protect the board from embarrassment. 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.

2. **Monitoring performance**

While the corporation laws literally provide 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 actually to manage, but to oversee the management of the corporation by monitoring the performance of the CEO and other senior officers. To enable the board to monitor performance, the board and management together need to determine the information the board should receive. The board should not be overloaded with information and it is not necessary that the board receives all information that the CEO and senior management receive. Instead, the board should receive the information that it determines to be useful and periodically reassess its information needs. Basically, the board should receive financial information that readily enables it to understand results of operations, variations from budget, 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. By tracking these reports and articles, the board will avoid not only unpleasant surprises but also the possibility of being accused of ignoring problems that were known to others and that could have been known by the directors. In addition, the board should promote lines of communication that will foster open and frank discussions with senior management, and management should be comfortable in informing the board or relevant committee of issues and developments.

3. **Monitoring compliance**

Compliance with laws and regulations is part of an effective risk management system. The board does not have a duty to ferret out compliance problems, but it is required to implement appropriate monitoring systems and take appropriate action when it becomes aware of a problem and believes that management is not properly dealing with it. In monitoring compliance, the board must be sensitive to "red flags" and "yellow flags" and should investigate as appropriate.

4. 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, and reassessed as economic conditions evolve. Many companies find it productive to include an annual strategy review in a board retreat of the type described further below. Pressures to focus unduly on short-term stock price performance present real challenges in crafting and maintaining long-term growth strategies, and the board's ability to craft a strategic vision and manage these pressures can be essential to the overall best interests of shareholders.

5. Crisis management

The current economic turmoil has generated a host of critical issues and challenges for many companies. Boards today should be particularly attuned to the risk profiles and vulnerabilities of their companies, with a view toward anticipating potential crises. Once a crisis starts to unfold, boards need to be proactive in taking the reins. The first decision a board must make during a crisis is 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.

In some cases, boards appear either to have 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. In particular, the proliferation of independent investigations by special committees (or by audit committees), each with its own counsel and perhaps forensic accountants and other advisors, can be time-consuming and distracting, can sour relationships between independent directors and management, and in extreme cases can result in the lawyers for the special committee hijacking the company and monopolizing the attention of directors and senior management.

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 it as a collegial body working in unison. While there may be an impulse to resign from the board upon the discovery of a crisis, directors are best served in most instances if they stay on the board until the crisis has been fully vetted and brought under control. In addition, although outside advisors (counsel, auditors, consultants and bankers) can play a very useful and often critical role in gathering the relevant facts 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.

IV. THE COMPOSITION AND STRUCTURE OF THE BOARD

1. Independence

The emphasis on director independence should not cause the board to lose sight of the importance of 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 perhaps one other current or former officer.

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 collegiality and relationship with the CEO that are necessary for the board and CEO to together promote the appropriate tone at the top, 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 that are unbiased by personal considerations. The concept of directors as remote strangers and the board as the agency for the discipline of management, rather than as an advisor to management in setting the strategic course of the corporation, is contrary to all prior experience and will not lead to better performance.

Nonetheless, a director should be careful in the current environment to make full and complete disclosure of any relationships or transactions that could be deemed to affect independence. SEC rules require companies to identify their independent directors (based on applicable NYSE or NASDAQ standards) and to disclose any transactions or relationships that were considered in determining that those directors were independent. 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 in 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.

2. Recruitment and nomination of director candidates

It has become increasingly difficult for companies to recruit directors with the requisite experience and qualifications, and as a result, the recruitment and nomination of director candidates has become a key priority for many boards. The Sarbanes-Oxley Act has resulted in a pronounced increase in the workload and risks associated with directorships. In addition, the narrowing definition of director independence, and objections by activists to even minor connections to the company as impediments to independence, has further limited the pool of potential recruits. The economic crisis has compounded these pressures by significantly increasing the workloads of many directors — in some cases requiring numerous special board meetings for companies dealing with crises. And, not surprisingly, shareholder litigation and other public attacks on board members have undermined the willingness of some of the most qualified individuals to take on new directorships.

The foremost criterion for director candidates is competence: boards should consist of well-qualified men and women with appropriate business and industry experience. If the CEO is the sole management representative, consideration may also be given to adding a second or third management representative, such as the COO, CFO or chief risk officer, to provide an additional source of direct input and information on the company's business,

operations, and risk profile in the boardroom. The second most important yet often underemphasized consideration is collegiality. A balkanized board is a dysfunctional board; a board works best when it works as a unified whole, without camps or factions and without internal divisions. 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. Diversity of views and backgrounds can also enhance boardroom discussions.

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 responsibilities. To this end, companies should consider including in their corporate governance guidelines policies limiting the number of boards on which a director may sit. While active CEOs are often uniquely qualified to provide business and strategic advice, the significant demands on their time may make it difficult for them to serve on multiple outside boards. Companies should also consider whether it would be advisable for them to impose term or age limits on directors.

V. BOARD COMMITTEES

The NYSE requires a listed company to have an audit committee, a compensation committee and a nominating and governance committee, each composed solely of independent directors. The SEC requires disclosures intended to prevent "interlocking" compensation committees between public companies as well as disclosures regarding the financial expertise of audit committee members. All companies should carefully consider which directors satisfy the requirements for service on committees, and questionnaires may be used to determine and document both independence and qualifications.

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 discussions or work of the committee. Indeed, it would be virtually impossible for the committees to function effectively without the participation of the CEO. Compensation matters, including the CEO's compensation, as well as governance and director nomination matters, should be discussed with the CEO. While the committee is tasked with making the recommendation to the board, there is no restriction on full discussion with the CEO. Nor is there any restriction on the CEO informing the board of any disagreement the CEO has with the committee.

The committees should have the authority to retain consultants and advisors, but there is no requirement that consultants be retained if the committee believes that it does not need such assistance. Indeed, shareholder activists and newspaper commentators have been critical of the use of compensation consultants, and while committees may continue to use such consultants if they believe that they provide a valuable service, they should be careful to exercise their own independent judgment and not to over-rely on consultants. A corporation's own general counsel or CFO can often 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 and its board, rather than "independent" counsel that has had no such relationship.

In addition to the core committees, boards may wish to establish additional standing committees to meet 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 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 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 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.

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 as a whole. In a regulatory environment where audit, compensation, and nominating and governance committees must be composed solely of independent directors, and where those committees are tasked with ever increasing responsibilities, it is particularly important that boards avoid balkanization and keep the full board, as well as management, apprised of significant actions.

1. 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. Board and committee meetings should be regularly scheduled and should provide sufficient time for directors to discuss the matters on the agenda.

2. Audit committee

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 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. The audit committee should also satisfy itself, by getting regular reports from 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. A more comprehensive overview of the responsibilities and procedures of audit committees is set forth in our Audit Committee Guide, which may be accessed at this link: Audit Committee Guide.

3. Risk management committee

In many companies, the scope and complexity of risk management may make it desirable to create a dedicated risk management committee or a separate subcommittee of the audit committee in order to permit greater focus at the board level on risk management. Given the myriad obligations specifically mandated or delegated to it by law and regulations, the audit committee may not have sufficient time to devote to optimal risk oversight, and its focus on compliance with auditing and accounting standards is not necessarily the right focus for identifying and assessing the broad array of risks that the company may face. Indeed, it is quite possible for strict compliance with accounting rules to mask risk, as occurred with the creation of structured investment vehicles and other off-balance sheet entities. Some of the advantages of a separate risk management committee are discussed further in the memorandum, "Risk Management and the Board of Directors," which is referenced and linked above. If the company keeps the risk oversight function in the audit committee and does not establish a separate risk committee or subcommittee, the audit committee should schedule time for periodic review of risk management outside the context of its role in reviewing financial statements and accounting compliance. While this may further burden the audit committee, it is important to allocate sufficient time and focus to the risk oversight role specifically.

4. Nominating and governance committee

The responsibilities of the nominating and governance committee have become particularly important given the increased challenges in recruiting qualified director candidates and the evolving pressures exerted by shareholder activists and hedge funds. A number of key issues and considerations relevant to the nominating and governance committee are discussed in Part II above under "Director elections" and "Separation of the chairman and CEO positions," and in Part IV above under "Independence" and "Recruitment and nomination of director candidates."

5. Compensation committee

As discussed above, compensation committees should carefully review pay policies in light of pay-for-performance principles and the interaction between pay packages and risk-taking incentives, while remaining focused on the need for compensation structures that will permit the company to recruit and retain first-rate executives. See the section titled "Executive compensation" in Part II above. The section titled "Director compensation" in Part VI below discusses issues relevant to the compensation committee in setting compensation for the board. A more comprehensive overview of the responsibilities and procedures of compensation committees is set forth in our Compensation Committee Guide, which may be accessed at this link: Compensation Committee Guide.

VI. BOARD PROCEDURES

1. Executive sessions

The NYSE requires the non-management directors to meet in regularly scheduled executive sessions of the board at which management is not present. Each board should determine the frequency and agenda for these meetings, although in practice, the trend has been towards scheduling regular executive sessions at every board meeting. A survey issued by the

Business Roundtable last year indicates that 71 percent of respondents expected their non-management directors to meet in executive session at every board meeting, representing an increase of 26 percent from four years earlier.

Executive sessions 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, and should not usurp functions that are properly the province of the full board. Boards should be careful that the use of executive sessions does not have a corrosive effect on board collegiality and relations with the CEO.

2. Director education

Boards should consider the desirability of an annual two to three-day board retreat with the senior executives, and where appropriate outside advisors, at which there is a full review of the corporation's financial statements and disclosure policies, risk profile, strategy and long-range plans, budget, objectives and mission, succession planning and current developments in corporate governance. To the extent that directors lack the knowledge required for them to have a strong grasp of important issues, companies should consider the usefulness of tutorials for directors, as a supplement to board and committee meetings and in order to keep directors abreast of current industry and company-specific developments and specialized issues. Training and tutorials should be tailored to the issues most relevant and important to the company and its business. Site visits may also be valuable for directors where physical inspection is important for more fully understanding the business and operations of a company.

Corporations should also provide comprehensive orientation for new directors. The annual retreat could satisfy a major portion of such an orientation. The content of orientation and training programs should be reviewed to make sure that such programs enable new directors to gain an understanding of the company's business quickly, and an overview of the company's risk profile should be incorporated into that training. If necessary, additional time and content should be devoted to educating new directors so that they have a full picture of the company.

3. Charters, codes, guidelines and checklists

The SEC and the NYSE have imposed various requirements on corporations relating to the adoption and/or disclosure of a code of ethics, corporate governance guidelines, policies and procedures for reviewing related party transactions and charters for audit, compensation and nominating committees. There is no end to the number of recommended checklists designed to assist corporations in complying with these requirements. 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. In addition, 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 a lack of due care.

The creation of charters and checklists is an art that requires experience and careful thought. It is a mistake simply 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 all of the provisions that other companies have. 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.

4. Confidentiality and the role of directors outside the boardroom

Confidentiality is essential for an effective board process and for the protection of the corporation and its stockholders. A board should function as a collegial body, and directors should respect the confidentiality of all discussions that take place in the boardroom. 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.

5. Minutes

Careful and appropriate minutes should be kept of all board and committee meetings. 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 adequately support the recollection of the directors as to what transpired. The minutes should reflect the discussions and the time that was spent on significant issues, both in the meeting and prior to the meeting, and should indicate all those who were present at the meeting and the matters for which they were present or recused. 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. Taking appropriate minutes is an art and the secretary of the company and the general counsel should work with the directors (and outside counsel where appropriate) to ensure that the written record properly reflects the discussion and decisions taken by the board.

6. Board, committee and CEO evaluations

The NYSE requires the board and the audit, compensation and nominating and governance committees to conduct an annual self-evaluation to determine whether they are functioning effectively. In addition, boards should take steps that will assure constituents (including regulators) that the CEO and senior management are being properly evaluated. Many consulting firms have published their recommended forms and procedures for conducting these evaluations and have established advisory services in which they meet with the board and committee members to lead them through the evaluation process. However, 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. Many boards have found that a discussion with or without an outside consultant is the best way to conduct evaluations. It should be noted that documents and minutes created as part of the evaluation process are not privileged, and care should be taken to avoid damaging the collegiality of the board or creating ambiguous records that may be used in litigation against the corporation and the board.

7. Reliance on advisors

In discharging their 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 needed. However, the board should also guard against overuse of outside advisors. The parade of lawyers, accountants, consultants and auditors through board and committee meetings can have a demeaning effect. While it is salutary for boards to be well advised and outside experts may be necessary to deal with a crisis, over-reliance on experts tends to reduce boardroom collegiality, distract from the board's role as strategic advisor, and call into question who is in control — the directors or their army of advisors.

8. Director compensation

Director compensation is one of the more difficult issues on the corporate governance agenda, as the need to appropriately compensate directors for their time and efforts must be balanced against the risk that generous compensation may raise an issue of independence. Over the last few years, the former factor has predominated, and director pay has increased significantly as more is expected of directors in terms of time commitment, responsibility and exposure to public scrutiny and potential liability.

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, including special committees formed to review major transactions or litigation. The SEC's revised disclosure rules call for enhanced tabular and narrative disclosure of all director compensation, including cash fees, equity awards, and deferred and other compensation.

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.

9. Whistle-blowers

Boards, and in particular audit committees, are required to establish procedures to enable employees to submit concerns, confidentially and anonymously, that 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. A reasonable procedure should be established to filter whistle-blower complaints and identify those that merit investigation. 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.

10. Major transactions

Board consideration of major transactions, such as acquisitions, mergers, spin-offs, investments and financings, needs to be carefully structured so that the board receives the information necessary in order to make an informed and 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. As noted above, however, outside financial and legal advisors will be needed to assist the board in reviewing the unique issues that arise when a company is in the "zone of insolvency."

There is generally 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 not involving a specific conflict of interest is usually 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, by means of a two-step process with the actual approval coming only after an initial presentation and the board having had time for reflection.

11. Related party transactions

Boards are generally 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 can be in the best interest 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 board 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.

In 2006, the SEC revised the disclosures for related party transactions to include a discussion of the company's "policies and procedures for the review, approval or ratification" of related party transactions, and boards should revisit their method for dealing with related party transactions and strongly consider adopting a formal written policy. The board, or an appropriate committee of directors who are both independent and disinterested with respect to the transaction under consideration, should evaluate each proposed related party transaction on both an initial and an ongoing basis and assure itself that all continuing related party transactions remain in the best interest of the corporation. The committee should have the authority to hire such outside financial, legal and other advisors as it deems appropriate.

VII. DIRECTOR LIABILITY

1. Personal liability of directors

Notwithstanding the wave of subprime-related and other litigation that is being generated by the economic crisis, the business judgment rule remains alive and well. Caremark and other Delaware cases have established that directors will not be liable for a failure of board oversight unless they intentionally failed entirely to implement any reporting or information system or controls or, having implemented such a system, intentionally refused to monitor the system or act on any warnings it provided. It is well-established that the board is not required to undertake extraordinary efforts to uncover non-compliance within the company, and it is generally difficult to show a breach of fiduciary duty for failure to exercise oversight. However, as noted earlier in this memorandum, the current economic crisis and the heightened focus on the board's oversight role create the risk that this deferential standard may be revisited. Boards should recognize the possibility that what constitutes a "red flag" and what constitutes conscious disregard may be evaluated in the future with heightened focus. Moreover, it is important to note that courts have taken the view that a breach of duty for failure to exercise oversight would be a breach of the duty of loyalty, which is not subject to exculpation or indemnification by the company. Accordingly, a board is best advised to act well above the minimal standards established by Caremark and its progeny.

In addition, the federal securities laws pose a separate threat of personal liability apart from state law fiduciary duties. The WorldCom and Enron settlements, in which directors agreed to personal payments, were federal securities law cases. Directors are liable for material misstatements in or omissions from registration statements that the company has used to sell securities unless the directors show that they exercised due diligence. To meet their due diligence obligation, directors should review and have a general understanding of 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 are also well advised to have the corporation's legal counsel present for the directors' review of the SEC disclosure documents and to receive the advice of counsel that the process they have followed

fulfills their due diligence obligation. While directors are not expected to focus on all comments made by the staff of the SEC, it is appropriate for them to have an understanding of significant changes made in response to SEC comments and any unresolved comments, to the extent material to the company.

2. Indemnification, exculpation and D&O coverage

Given the heightened risk of litigation stemming from recent market conditions, boards should ensure they have state-of-the-art indemnification and D&O arrangements. 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 regularly to ensure they provide the fullest coverage available.

Earlier this year, a Delaware court indicated that bylaws may be amended to eliminate the right of former directors to expense advancement, and the court's reasoning could be interpreted to likewise permit bylaw amendments that limit indemnification rights of former directors. The court's decision highlights the need for companies to review, and if necessary revise, their indemnification and expense advancement provisions to ensure that the rights of directors and officers will be protected as intended.

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 purchase separate supplemental insurance policies covering just the directors and officers individually (so-called "side-A" coverage) in addition to their normal policies that cover both the company and the directors and officers individually.