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Some Thoughts for Boards of Directors in 2008

By Martin Lipton



AEI LEGAL CENTER
FOR THE PUBLIC INTEREST

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PREFACE

In September, the National Legal Center for the Public Interest became a part of the American Enterprise Institute to form the AEI Legal Center for the Public Interest. The AEILC pursues an expanded program of research, publications, and conferences on legal and constitutional issues drawing on the traditions, interests, and people of both AEI and NLCPI. In this first issue of the *Briefly* series under the auspices of the AEI Legal Center, noted corporate attorney Martin Lipton comments on some of the most significant issues facing boards of directors in 2008. In this update of his well-received December 2006 *Briefly, Deconstructing American Business II and Some Thoughts for Boards of Directors in 2007*, Mr. Lipton addresses the problems of shareholder activism and long-term and short-term stock-market pressures, as well as the shift in the board's role from strategy and advising to compliance and regulation. He also offers advice for boards on everything from corporation monitoring and corporate strategy to CEO selection, crisis management, and compensation.

Like all other publications of the National Legal Center, and now the AEI Legal Center for the Public Interest, this *Briefly* is presented to encourage a greater understanding of the law and its processes. The views expressed in this monograph are those of the author and do not necessarily reflect the opinions of the Center or its scholars. The *Briefly* series consists of short, insightful treatments of leading legal issues of interest to the private sector.

Theodore H. Frank

Director

AEI Legal Center for the Public Interest

INTRODUCTION

More than five years after the enactment of the Sarbanes-Oxley Act of 2002,¹ it has become clear that the decisive reaction by governance reformists to Enron and other scandals has proven to be an overreaction, and measures designed to protect shareholder value are impeding its creation. In particular, a key challenge facing boards of directors has emerged with new urgency: the task of promoting long-term value for shareholders in the face of tremendous pressures to realize short-term stock-market gains. These pressures have become acute as hedge funds and other activist shareholders, as well as influential proxy advisory firms, have sought to reshape the landscape in ways that undermine the board-centric model of governance, including their efforts to (a) mandate shareholder referenda on material decisions, including compensation decisions; (b) dilute the ability of companies to defend against hostile takeovers; (c) increase shareholder access to company proxy statements for shareholder-nominated director candidates and other shareholder proposals; (d) influence the membership of boards by means of majority voting proposals and withhold-the-vote campaigns; and (e) circumvent the CEO and exert influence by means of direct lines of communications with directors. As decision-making power shifts from boards to activist shareholders and shareholder advocates, boards are increasingly vulnerable to pressures for short-term share price performance and other agendas.

Furthermore, the corporate governance changes that are being precipitated by these pressures, as well as the procedural imperatives imposed by regulatory and legal reforms, have furthered the shift in the board's role from guiding strategy and advising management to ensuring compliance and performing due diligence. Directors must navigate a maze of procedural and accounting requirements and a litany of ever-evolving best practices. Boards today are spending more time and energy on compliance, due diligence and investigations, and less on the actual business of their companies and the pursuit of long-term value creation. To be sure, procedural requirements are important safeguards, and monitoring is a core board function, but the key is to strike the right balance.

¹ Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.) (2002).

The need to critically evaluate these trends, rather than passively adhering to the shareholder rights and other activist mantras of the post-Enron period, has become grave. The demonstrated genius of the large public corporation has been its ability to harness equity, debt and human resources to invest in large projects with long-term investment horizons, and the success of such ventures has been integral to the remarkable flourishing of the U.S. economy over time. To the extent that boards are increasingly vulnerable to demands for short-term gains, these trends promise to have repercussions not just for the role of the corporate board but for American business more generally.

This monograph sets forth some of the significant issues that boards of directors will face in the coming year, as well as some practical considerations to bear in mind. 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" and the board of each corporation can and should tailor procedures to its own circumstances.

SOME KEY ISSUES FACING BOARDS IN 2008

Balancing short-term performance and long-term success

Activist shareholders, including hedge funds and other special interest groups, will continue their multi-pronged campaigns to shift decision-making power away from boards in the coming year, with the effect of further exacerbating the tension between short-term performance and long-term success of corporations.

The most obvious instances of these efforts are demands by hedge funds for corporate actions that will directly result in short-term gains for shareholders, including large or special dividends, diversion of capital expenditure to fund equity buybacks, transactions that would reduce high-rated corporate debt to junk status, divestitures of businesses, facility closures and employee head-count 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 they will insist that those plans be truncated for a quick increase in stock price. Directors should periodically review the company's plans for dealing with an attack by activists.

In addition, the board's traditional function as a bulwark of long-term value is being whittled down 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 discretion and judgment with shareholder prerogatives. Boards need to guard against becoming increasingly risk averse and increasingly responsive to short-term pressures.

Another source of "short-termism" is the practice of issuing quarterly earnings guidance. This practice began in the early 1990s in response to demands from institutional investors and research analysts for increased discipline and corporate transparency. As Daniel Vasella, CEO of Novartis, has remarked, this 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.”² Earlier this year, reports issued by the Aspen Institute and an independent commission established by the U.S. Chamber of Commerce called for the permanent elimination of quarterly earnings guidance, and it remains to be seen whether the anti-quarterly-guidance movement will gain traction in 2008.

Director elections

The dynamics of director elections have been evolving in response to several developments. First, withhold-the-vote campaigns have the potential to become increasingly effective as a result of the widespread adoption of majority voting standards and related resignation policies. Over the past two years, activist shareholders have focused particular attention on efforts to persuade corporations to adopt majority voting for director elections. In response, Intel, FedEx, Cisco and many other companies have amended their bylaws to implement a majority voting standard for uncontested elections and require directors to tender their resignations to the board for consideration in the event such directors receive more “withheld” or “against” votes than “for” votes in an uncontested election.

ISS Governance Services, now a division of RiskMetrics Group, usually recommends voting in favor of majority voting bylaws, even for companies that have adopted resignation policies to address situations where directors fail to receive a majority of shareholder votes. In addition, majority voting has been further encouraged by changes in 2006 to the Delaware General Corporation Law³ which prevent boards from amending director election bylaws that have been adopted by shareholders. In short, it is clear today that majority voting will become universal. In light of the ISS position and in an effort to avoid shareholder proxy proposals, it is advisable for companies to consider proactively adopting a majority voting bylaw.

The impact of both withhold-the-vote campaigns and majority voting policies on director elections may be compounded by a proposed New York

² Daniel Vasella & Clifton Leaf, *Temptation Is All Around Us*, *Fortune*, Nov. 18, 2002, at 109.

³ 75 Del. Laws c. 306 (2006).

Stock Exchange rule amendment that would make uncontested director elections non-routine matters for purposes of NYSE Rule 452, thereby preventing discretionary broker voting in such elections. Campaigns to vote against or withhold votes for directors would accordingly not be diluted by the often significant block of broker discretionary votes voting in favor of the company’s director nominees. While the NYSE indicated in September that the proposed amendment will not be effective for the 2008 proxy season, it noted that the SEC is considering it “as part of a broad range of issues relating to shareholder communications and proxy access.”

In addition, ISS has stated that if a director who it believes merits a “withhold” or “against” recommendation cannot be targeted because the board is classified and the director’s class is not up for election that year, ISS may recommend voting against or withholding votes from any or all directors who are up for election (except new nominees).

Shareholder activism may also be aided by new SEC rules that permit Internet distribution of proxy statements. Since July, companies and other soliciting parties may satisfy their proxy information delivery requirements by posting their materials on the Internet and sending a notice that meets certain requirements to shareholders at least 40 days in advance of the meeting date. These e-proxy rules make it less expensive for activist shareholders to wage withhold-the-vote campaigns or proxy contests for board representation.

Considerable attention has been focused this year on shareholder access to company proxy statements for director nominations. In 2006, a decision by the Second Circuit Court of Appeals undermined the long-standing rule that shareholder proposals seeking proxy statement access for board nominations may be excluded from a company’s proxy statement. The SEC subsequently issued two proposals—one that would codify the traditional exclusion rule, and the other that would allow shareholders owning five percent or more of a company’s voting shares to include in the company’s proxy materials a proposed bylaw amendment that would mandate procedures for allowing shareholders to include director nominations in the company’s proxy materials.

Last month, the SEC voted to adopt the proposal that reaffirms that a company may categorically exclude such shareholder proposals for proxy

access. 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’s attention from the business to electoral campaigning, encourage short-term thinking, and lead to a rise in director candidates representing special interests. SEC Chairman Cox has stated, however, that discussion of proxy access will be reopened in 2008.

Shareholder proposals

Both the prevalence and forcefulness of shareholder proposals have been escalating over the past five years. Each year, many companies face a range of proposals advocating various corporate governance and other measures, including board declassification and dilution of other anti-takeover measures, shareholder approval of executive compensation levels and other business decisions, majority and cumulative voting standards for director elections, and a host of social, environmental and political policies.

On some issues, primarily related to 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, proxy voting advisers publish guides setting forth blanket voting policies on a variety of common issues that are frequent subjects of shareholder proposals. Many of these self-appointed watchdogs also publish corporate governance ratings and report cards that often apply one-size-fits-all governance metrics and shifting standards of good corporate governance. Institutional shareholders typically subscribe to the services of such proxy voting advisers, and many rely heavily on the 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.

Shareholder voting dynamics are being further complicated by “empty voting” arrangements, pursuant to which investors and particularly hedge funds hold more votes than economic ownership. As a result of this decoupling of voting power and economic ownership, the interests of these investors may not be aligned with—and, in the case of negative economic ownership, may be adverse to—the interests of the corporation’s other

shareholders. These arrangements often are difficult to detect, and to the extent these special interest groups are able to manipulate corporate decisions, there is no guarantee that such manipulation will benefit the corporation’s broader shareholder constituency in either the short or the long term.

The reactions of companies to shareholder proposals that receive majority support are being carefully monitored by reformists. Companies that decide not to implement these proposals are likely to face the same proposals yet again in the next proxy season, and there is a further risk that directors will be targeted by a withhold-the-vote campaign. ISS advises shareholders to vote against directors who fail to respond to proposals that receive majority support in two consecutive years.

Companies should carefully weigh opposition to shareholder proxy resolutions that can be accommodated without significant difficulty or harm to the company. Today, it is prudent to do a risk-reward analysis of shareholder resolutions, rather than to routinely oppose them. 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.

Direct lines of communication with shareholders

Public pension funds and other activist shareholders are increasingly seeking direct meetings with independent directors to express their views with respect to performance, governance, social and political issues and other matters. To craft an appropriate response, the board should take into account the company’s shareholder relations programs and consider whether it is appropriate for management or even the board to have greater interaction with shareholders. Where the corporation has significant performance or compliance issues, direct contact between institutional shareholders and nonmanagement directors may forestall a proxy initiative by shareholders.

In June 2007, Pfizer announced that members of its board would invite the company’s largest institutional shareholders to a meeting at which they would have an opportunity to provide comments and perspective on the

company's governance policies and practices. To the extent that boards agree to such meetings, they should take care to coordinate with the full board and management to avoid confusion or contradiction in the company's public posture, and they should be mindful of the requirements of Regulation FD.⁴

In addition, shareholders and shareholder advocates have introduced the idea of a board secretary or corporate governance officer—in essence, a lawyer whose sole clients are the independent directors of the company. Although direct communications with shareholders is an important and often uniquely effective element of a company's response to activism, the advent of working groups and a corporate officer position whose role is to appease shareholder activists heralds yet another new avenue of shareholder influence into boardroom deliberations.

Executive compensation

Executive compensation continues to be a high-profile corporate issue and a major focus of shareholder activism. One aspect of executive compensation reforms that has recently gained traction is the advocacy of “say on pay” policies that call for nonbinding shareholder ratification of executive compensation. ISS recently reported that these proposals received an average level of shareholder support of 41.7 percent at 41 meetings in the first half of 2007 and received a majority vote at seven companies. Both Verizon and Aflac have announced that they will hold a shareholder advisory vote on executive compensation at their 2009 annual meetings. In addition, Pfizer and several other large companies have formed a working group with union and pension funds representatives to discuss adoption of a “say on pay” policy. The issue has likewise gained traction in political forums. Last April, “say on pay” legislation received the approval of the U.S. House of Representatives, and a companion bill was promptly introduced in the Senate.

“Say on pay” and other initiatives designed to increase shareholder input on executive compensation matters will continue to be a central corporate governance issue in 2008. To the extent that these measures are designed to usurp the power of the compensation committee to use its judgment in determining executive compensation, they should be strongly resisted.

⁴ 17 C.F.R. §§ 240, 243, 249 (2000).

Similarly, although the 2008 ISS policy updates are critical of executive compensation practices such as excise tax gross-ups, single-trigger equity award vesting and postretirement perks, companies must assess these and other executive compensation arrangements in light of company-specific needs, rather than broad policy mandates.

Notwithstanding the attention that compensation practices have received, there is a general consensus that executive compensation should be aligned with long-term corporate performance and shareholder value, and that most companies, including well-performing ones, need to engage in recruiting and retention efforts to attract and retain qualified individuals. There is a wide spectrum of views as to how to achieve these objectives. The only really useful advice is to maintain a thoughtful process, full disclosure and recognition by the compensation committee that it should not be deterred by media attention and reformist pressures from doing what it feels is in the best interests of the corporation. In the final analysis, nothing is more important to the success of the corporation than its ability to recruit and retain world-class executives.

The “Compensation Discussion and Analysis” in proxy statements and related executive compensation disclosures will continue to receive close attention during the upcoming proxy season. Required disclosures regarding severance and change in control benefits, including tax gross-ups, will continue to attract the most interest. During 2007, the SEC provided significant guidance through frequently asked questions, company-specific comment letters and a published report on executive compensation disclosure. In particular, the SEC continues to press companies to disclose performance targets that are material to executive compensation policies and has challenged companies that have excluded performance targets on the basis that the disclosure of targets would result in competitive harm. In addition, the SEC guidance has emphasized the importance of clear and concise disclosure based on plain English principles.

“Option backdating” and other option grant practices will continue to be hot-button issues in 2008, with ongoing SEC and DOJ investigations as well as shareholder derivative suits. Earlier this year, the Delaware Court of Chancery issued two decisions that establish that directors may be vulnerable to liability for monetary damages for intentional stock option backdating and “spring-loading.” In light of these developments, compen-

sation committees should review their procedures periodically and consult with company counsel to be sure they are in compliance with all applicable requirements.

THE ROLE AND DUTIES OF THE BOARD

The past two decades have witnessed a transition from the advisory board to the monitoring board. While the board has always had a dual role as a resource for and adviser of management, on the one hand, and as an agent of shareholders on the other, in recent years regulators and activist shareholders have been tipping this balance with increasing force in favor of the board's role in monitoring compliance with legal and accounting rules. But it is still generally acknowledged that a combination of the two is necessary, and to be truly effective, 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 the operations of a board.

Tone at the top

An important factor 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 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 work with the CEO and senior management to review periodically the ways in which they are striving to set the right example for employees and other 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 helping to set the tone at the top, another critical job of the board is selecting and evaluating the CEO and the senior executive leadership of the corporation and planning for their succession. Indeed, recent Wall Street problems emphasize the importance of succession planning. 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 are 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 of outside candidates. A proven, well-qualified internal candidate, who is intimately familiar with the corporation's business and culture, is frequently the best choice.

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.

Here, less can be more, and the board should not be overloaded with information. It is not necessary that the board receive all information that the CEO and senior management receive. Instead, the board should receive the information that it determines to be useful and annually 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.

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 implement appropriate monitoring systems, and to take appropriate action when it becomes aware of a problem and believes that management is not properly dealing with it. In normal situations, it is sufficient for the board to review compliance matters and litigation semiannually. This may be done directly by the board or through the audit committee or another committee. However the review 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 also report to the board or the committee. In addition, the board should oversee an annual review of the corporation's compliance and governance programs as well as 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" and should investigate, as appropriate, and document its monitoring activities in minutes that accurately convey its time and effort. 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 of whether or not to charge a company with wrongdoing.

Review of controls and risk management

The board should—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, violations 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 reputational risks. The board should consider whether each category of risk is addressed by the company's risk management procedures.

It is an important responsibility of management to establish and maintain adequate internal controls 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, as amended in May 2007, the independent auditor must express an opinion on the effectiveness of internal controls in its audit report. The rules also call for a quarterly evaluation and certification by management of a company's internal controls and procedures for financial reporting, and the SEC has now adopted interpretive guidance for management to consider in performing its assessments.

Accordingly, 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 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 Generally Accepted Accounting Principles and gives "reasonable assurance" of accuracy in financial reports, and that management designs and supervises processes that adequately identify, address and control compliance risks. Boards should seek to make sure that the company addresses any deficiencies that are discovered, but should avoid overreacting to such deficiencies.

Effectiveness of the board

A board's failure to allot adequate time to carry out its duties could call into question whether it has 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, objectives and mission, succession planning and current developments in corporate governance.

Corporations should also provide comprehensive orientation for new directors. The annual retreat could satisfy a major portion of such an orientation. In addition, corporations should provide education programs for continuing directors, both to enhance their skills as directors as well as to help them stay abreast of developments.

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 of the type described previously. As noted earlier in this monograph, pressures to unduly focus 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.

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 precipitate or exacerbate a crisis. The proliferation of independent investigations by special committees (or by audit committees), each with its own counsel and perhaps forensic accountants and other advisers, can be time-consuming and distracting, can sour relationships between independent directors and management, and in extreme cases result in the lawyers for the special committee hijacking the company and monopolizing the attention of directors and senior management.

Boards have responded to recent crises with varying degrees of success. Many boards have functioned very well in taking a careful measure of the situation and then implementing the right procedures for obtaining the necessary information about the issues facing the corporation, developing the right strategies for responding to the situation and rectifying any management, disclosure or legal/compliance deficiencies. Others, however, appear 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. 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.

During a crisis, the first decision a board must make 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 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 advisers (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 advisers.

THE COMPOSITION AND STRUCTURE OF THE BOARD

Separating the roles of chairman and CEO; lead director

Most American companies traditionally have had a single individual who fulfills the roles of both chairman of the board and CEO. There is a growing effort by shareholder activists calling for the separation of these roles, and many boards have accommodated these demands. According to ISS data, while approximately 73 percent of companies combined these roles in 2002, this number dropped to approximately 55 percent in 2007.

Although 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 nonexecutive 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.

To be effective, the lead director 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 generally does 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 that his or her name 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

The emphasis on board independence should not cause the board to lose 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 perhaps 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 antitheses of the kind of collegiality and relationship with the CEO that is 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 adviser 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.

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 the independent directors of the company (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. 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.

Nomination of director candidates

Shareholders can propose potential director candidates to the nominating committee, and the nominating committee has a duty to consider all bona fide candidates and to nominate directors whom it believes will best serve the interests of the company and its shareholders. In evaluating potential candidates, whether they are proposed by management or shareholders, the nominating committee should consider 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 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. 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 often are 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.

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. Diversity is also important. 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.

Despite the great advantages of a nominating committee that can evaluate potential director candidates, the traditional nominating system is under attack by activists who believe that shareholders should have greater power to nominate directors. The principal goal of this movement has been “proxy access,” which, as mentioned previously, would require that under certain circumstances, companies include shareholder-nominated director candidates in their proxy statements and on their forms of proxy. This would allow shareholders to propose their own candidates without either the approval of the nominating committee or the expense of a proxy fight.

BOARD COMMITTEES

The NYSE requires a listed company to have an audit committee, a compensation committee and a nominating committee, each consisting solely of independent directors. The SEC imposes expertise requirements on members of a company’s audit committee, as well as disclosure requirements intended to prevent “interlocking” compensation committees between public companies. 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. Although 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 advisers, 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 not to overrely on consultants and to exercise their own independent judgment. As a general rule, 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 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 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 advisers may take a matter in a direction that would be different than that desired by the full board. 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 as a whole. In a regulatory environment where audit, compensation and nominating 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.

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 agendas 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.

Nominating and governance committee

In the coming year, the spotlight will be increasingly focused on the governance and nominating committee. Following the enactment of the Sarbanes-Oxley Act, the emphasis initially was on the role of the audit committee, and thereafter some attention shifted to the compensation committee. Now, the governance and nominating committee will increasingly come to the fore, as companies must navigate and respond to pressures resulting from majority voting standards, withhold-the-vote campaigns, proposals for shareholder access to company proxy statements and other governance issues.

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 presented fairly.

BOARD PROCEDURES

Executive sessions

The NYSE requires the nonmanagement 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, and boards should be careful that use of executive sessions does not have a corrosive effect on board collegiality and relations with the CEO.

Charters, codes, guidelines and checklists

The audit, compensation and nominating committees are required to have charters. The corporation is required to have a code of ethics and a set of policies and procedures for reviewing related party transactions. The board is required to have corporate governance guidelines, and there is almost 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 all of the provisions that other companies have. Charters and checklists should be reviewed carefully each year to prune unnecessary items and

to add only those items that will help directors in discharging their duties.

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 regarding 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 nonexecutive 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 in order to avoid confusion in the corporation’s public statements and posture.

The basic principles outlined above also have application in responding to public pension funds that demand to meet not just with management but with independent directors to express their views with respect to perfor-

mance, governance, social issues and political matters. While boards may reasonably decide to agree to such meetings to avoid high-profile public battles with activist shareholders, they should take care to coordinate such meetings with the full board and management to avoid confusion or contradiction in the company's public posture.

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.

In addition, a Delaware decision issued in March of 2007 condemned the common practice of providing drafts of board and committee meeting minutes to directors for approval a substantial period of time (several months in the case in question) after the meeting. Drafts of minutes should be promptly prepared and circulated to directors for their consideration.

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 best to conduct its own evaluation. In making the decision, note 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 perfectly 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 damaging the collegiality of the board and creating ambiguous records that may be used in litigation against the corporation and the board.

Reliance on advisers

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 advisers. 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.

The board also should guard against overuse of outside advisers. In an address I gave last February, I noted:

[t]he demeaning effect of the parade of lawyers, accountants, consultants and auditors through board and committee meetings . . . A corollary of the transformation of the role of the board from strategy and advice to investigation and compliance is an increased reliance on experts in the boardroom. While it is salutary for boards to be well advised, 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 advisers.⁵

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 signifi-

⁵ Martin Lipton, Shareholder Activism and the "Eclipse of the Public Corporation," Keynote Address at the 25th Annual Institute on Federal Securities (Feb. 7, 2007).

cantly 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 litigations. The SEC's revised disclosure rules now 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 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 scrutinized to make sure that they do not jeopardize a director's independence or create any potential appearance of impropriety. Per-meeting fees should be used with care, as such fees may send a message that meeting attendance is "extra" or that the board could call meetings simply to generate additional fees.

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. 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 offi-

cer 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.

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 to make an informed and reasoned decision. This does not mean that outside advisers 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 not involving a specific conflict of interest 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 enough 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

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 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 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 are 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. Management should make sure that all related party transactions have been fully and carefully reviewed with the board. 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 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 advisers as it deems appropriate to assist it in its evaluation of such transactions.

DIRECTOR LIABILITY

Personal liability of directors

The 2005 decision of the Delaware Chancery Court in the *Disney* case,⁶ upheld by the Delaware Supreme Court in June of 2006, 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 monetary liability (assuming a typical exculpation clause) unless the director failed to act in “good faith.” The Delaware Supreme Court ruled that a director fails to act in good faith if he or she (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.”⁷ The Chancery Court noted 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.”⁸ 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.”⁹

In November of 2006, the Delaware Supreme Court held in *Stone v. Ritter*¹⁰ that directors acting in good faith (under the principles articulated in *Disney*) could not be held liable for lack of oversight of officers and employees. Director liability for lack of oversight—referred to as “*Caremark*” liability based on the seminal case decided in 1996¹¹—requires a finding that the directors either (1) “utterly failed to implement any reporting or

⁶ *In re* The Walt Disney Company Derivative Litigation, 907 A.2d 693 (Del. Ch. 2005).

⁷ *In re* The Walt Disney Company Derivative Litigation, 906 A.2d 27, 67 (Del. Supr. 2006).

⁸ See *Disney*, *supra* n. 7, at 697.

⁹ *Id.* at 698.

¹⁰ *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. Supr. 2006).

¹¹ *In re* Caremark Int'l Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996).

information system or controls” or, (2) having implemented such system or controls, “consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.”¹² In either case, the Delaware Supreme Court ruled that the “imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.”¹³

The federal securities laws pose a greater threat of personal liability than state law fiduciary duties. The WorldCom and Enron settlements, in which the directors agreed to personal payments, were federal securities law cases. Directors are liable for material misstatements in or omissions from registration statements the company has used to sell securities unless the directors show that they exercised due diligence.

To meet their due diligence requirements, directors must 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 experts are not qualified or are conflicted or that the disclosure is actually false or misleading. Directors should not merely accept management’s representations that a registration statement is accurate. They are also well advised to have the corporation’s legal counsel present for the directors’ review of SEC disclosure documents and to receive the advice of counsel that the process they have followed fulfills their due diligence obligations.

In a speech presented last year, John White, director of the SEC Division of Corporation Finance, advised directors:

If I were a director, I would want to make sure I receive a copy of each of my company’s comment letters and, equally important, the responses my company submitted. Understand the questions the [SEC] has asked, the answers the company has provided and the revisions it has made for its filings. Use that understanding, then, to help set the benchmarks for your company’s future disclosures. I do not mean to suggest that directors need to be at the front lines of preparing their companies’ public filings. You do

need to understand your company’s disclosures, however, and this can be one more tool in your toolbox to do that. It will not do the whole job for you, but it can help.¹⁴

While directors are not expected to focus on all SEC staff comments, it is appropriate for them to have an understanding of significant changes made in response to comments and any unresolved comments.

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 ensuring that a court respects the applicability of exculpatory charter provisions.

D&O coverage provides a key protection to directors. Even though such coverage has become more expensive in recent years, it is still available in most instances and remains highly useful. 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 among 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

¹² *Stone v. Ritter*, 370.

¹³ *Id.*

¹⁴ John W. White, Address at Practising Law Institute Fourth Annual Directors’ Institute on Corporate Governance: An Expansive View of Team Work: Directors, Management and the SEC (Sept. 25, 2006).

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.

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